

# AGENDA ITEM REQUEST FORM

Department: Rent Program

Department Head: Bill Lindsay

Phone: 620-6512

Meeting Date: May 24, 2017

Final Decision Date Deadline: May 24, 2017

**STATEMENT OF THE ISSUE:** The Richmond Fair Rent, Just Cause for Eviction, and Homeowner Protection Ordinance ("Ordinance") provides for a petition process, whereby Landlords and Tenants may submit a petition for an upward or downward adjustment in the Maximum Allowable Rent. Furthermore, in lieu of filing a civil action, a Tenant may file an administrative complaint. Section 11.100.100(b)(1) of the Ordinance provides that the rules and regulations adopted by the Board shall provide for final Board action on any complaint for Excess Rent within one-hundred twenty (120) days following the date of filing the complaint. The establishment of interim guidelines is necessary to process the twenty-two (22) Excess Rent Complaints and forty-two (42) Rent Adjustment Petitions filed with the Rent Program as of May 17, 2017.

## INDICATE APPROPRIATE BODY

- |   |   |  |   |   |
|---|---|--|---|---|
| <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 type="checkbox"/> Other: <u>Rent Board</u>   |   |

## ITEM

- |   |  |   |
|---|--|---|
| <input type="checkbox"/> Presentation/Proclamation/Commendation (3-Minute Time Limit) |  |   |
| <input type="checkbox"/> Public Hearing   | <input type="checkbox"/> Ordinance   | <input type="checkbox"/> Other: <u>Training</u> |
| <input type="checkbox"/> Contract/Agreement   | <input type="checkbox"/> Council 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:** ADOPT Administrative Regulation 17-02 and DIRECT staff to establish and implement interim guidelines for hearing Rent Adjustment Petitions and Excess Rent Complaints.

AGENDA ITEM NO:

**I-2.**



# AGENDA REPORT

## RENT PROGRAM

**DATE:** May 24, 2017

**TO:** Chair Gray and Members of the Rent Board

**FROM:** Bill Lindsay, City Manager

**SUBJECT:** INTERIM GUIDELINES FOR HEARING RENT ADJUSTMENT PETITIONS AND EXCESS RENT COMPLAINTS

### STATEMENT OF THE ISSUE:

The Richmond Fair Rent, Just Cause for Eviction, and Homeowner Protection Ordinance ("Ordinance") provides for a petition process, whereby Landlords and Tenants may submit a petition for an upward or downward adjustment in the Maximum Allowable Rent. Furthermore, in lieu of filing a civil action, a Tenant may file an administrative complaint. Section 11.100.100(b)(1) of the Ordinance provides that the rules and regulations adopted by the Board shall provide for final Board action on any complaint for Excess Rent within one-hundred twenty (120) days following the date of filing the complaint. The establishment of interim guidelines is necessary to process the twenty-two (22) Excess Rent Complaints and forty-two (42) Rent Adjustment Petitions filed with the Rent Program as of May 17, 2017.

### RECOMMENDED ACTION:

ADOPT Administrative Regulation 17-02 and DIRECT staff to establish and implement interim guidelines for hearing Rent Adjustment Petitions and Excess Rent Complaints.

### FISCAL IMPACT:

On April 5, 2017, the Rent Board authorized staff to enter into a sole source contract with University of the Pacific McGeorge School of Law Institute for Administrative Justice (IAJ) for hearing officer services. The draft Fiscal Year 2017-18 Rent Program Budget assumes that each hearing will last approximately two hours at a rate of \$220.00 per hour.<sup>1</sup> As of May 17, 2017, the Rent Program has received twenty-two (22)

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<sup>1</sup> While the insertion of an assumption is necessary for budgetary purposes, based on staff members'

## ITEM I-2

Excess Rent Complaints and forty-two (42) petitions (Attachments 2 and 3). If each hearing lasts the full two hours, the associated cost will be \$27,280.

### **DISCUSSION:**

Section 11.100.070(d) provides that the Board shall enact rules and regulations governing hearings and appeals of individual adjustments of the Maximum Allowable Rent. During this interim period, before an Executive Director is hired and permanent staff members are retained, interim Rent Program legal counsel recommends utilization of the Maintenance of Net Operating Income (MNOI) methodology for making a fair rate of return determination (Attachment 4). Utilization of this approach, adopted in a myriad of other jurisdictions in the State of California with rent stabilization policies, will allow the Rent Program to process the forty-two petitions filed as of May 17, 2017, in a timely manner.

### **DOCUMENTS ATTACHED:**

Attachment 1 – Resolution of the Richmond Rent Board Adopting Administrative Regulation 17-02 Concerning Interim Regulations for Hearing Rent Adjustment Petitions and Excess Rent Complaints

Attachment 2 – Excess Rent Complaints Submitted as of May 17, 2017

Attachment 3 – Rent Adjustment Petitions Submitted as of May 17, 2017

Attachment 4 – Comment on Fair Return Analysis Pursuant to the Zoning Application of 2631 Durant St., Berkeley

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conversations with attorneys at the Institute for Administrative Justice, the duration of hearings is largely dependent on the complexity of the case. It is anticipated that a majority of hearings will be heard in less than two hours.

# ATTACHMENT 1

## RICHMOND RENT BOARD REGULATION 17-02

1. Petitions for a rent adjustment.
  - A. A petition for a rent adjustment shall be scheduled for hearing by the appointed hearing officer within 15 business days of the Rent Board's staff receipt of the petition and, as to a landlord filed petition, determination that the declaration of the landlord that the Rental Unit meets all the requirements of the Ordinance is true. The hearing examiner shall use best efforts to conduct the hearing on the petition within 45 days thereafter, recognizing, however, that the timeframe may need to be extended for good cause, for example, the need to conduct a current building inspection and/or the need for adequate time for records to be assembled, produced and reviewed by the party opposing the petition. The hearing examiner shall issue a written decision concerning the petition within 30 days of the close of the hearing; the hearing examiner may allow the parties to file letter briefs before the hearing is closed.
  - B. Any person aggrieved by the decision of the hearing examiner may appeal the decision to the Board by filing an appeal, on a form provided by the Board, within 15 business days from the date the Board sends a notice of the decision to the parties. The Board shall not conduct a de novo hearing on the petition but shall affirm, reverse or modify the decision of the hearing examiner based on the administrative record as set forth in Section 11.100.070 (d)(7), Richmond Municipal Code. The Board shall meet as soon as reasonable in order to consider the appeal and issue a decision. If an appeal is not filed timely in response to the hearing examiner's decision, that decision is final. If an appeal is timely filed, the Board's decision is final but subject to judicial review as set forth in Section 11.100.090, Richmond Municipal Code.
2. Administrative complaints for excess rent.
  - A. A tenant's administrative complaint under Section 11.100.100 (b), Richmond Municipal Code, shall be scheduled for hearing by the appointing hearing officer within 15 business days of the Rent Board's staff receipt of the complaint. For the administrative complaints that have been filed prior to June 1, 2017, the 15 business days shall start June 1, 2017. The hearing examiner shall use best efforts to conduct the hearing on the complaint within 30 days thereafter. The hearing examiner shall issue a written decision concerning the complaint within 21 days of the close of the hearing; the hearing examiner may allow the parties to file letter briefs before the hearing is closed.
  - B. Any person aggrieved by the decision of the hearing examiner may appeal the decision to the Board by filing an appeal, on a form provided by the Board, within 10 business days from the date the Board sends a notice of the decision to the parties. The Board shall not conduct a de novo hearing on the complaint but shall affirm, reverse or modify the decision of the hearing examiner based on the administrative record as compiled by the hearing examiner. The Board shall meet as soon as reasonable in order to consider the appeal and issue a decision. If an appeal is not filed timely in response to the hearing examiner's decision, that decision is final. If an appeal is timely filed, the Board's decision is final but subject to judicial review as set forth in Section 11.100.090, Richmond Municipal Code. The Board will have taken final action within 120 days on any administrative complaints for excess rents that were pending as of June 1, 2017 and on all administrative complaints filed on June 1, 2017 and thereafter.

# ATTACHMENT 1

Approved as to form on May 24, 2017:

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Michael Roush  
Interim Board Counsel  
Richmond Rent Board

## FORM SUBMISSION SUMMARY: EXCESS RENT COMPLAINTS

**Purpose:** In lieu of filing a civil action, a Tenant may file an administrative complaint. A Landlord who demands, accepts, receives, or retains any payment of Rent in excess of the Maximum Allowable Rent shall be liable for damages in the amount by which the payment or payments demanded, accepted, received, or retains exceeds the Maximum Allowable Rent . The rules and regulations adopted by the Board shall provide for final Board action on any complaint for excess Rent within one-hundred twenty (120) days following the date of filing of the complaint (RMC 11.100.100(b)(1-2)). **Total Excess Rent Complaints Submitted: 22**

| #  | Date Filed        | 120 Day Deadline for Final Board Action | Date Courtesy Compliance   Warning   Violation Letters Mailed | Current Rent/Base Rent |
|----|-------------------|---|---|------------------------|
| 1  | February 7, 2017  | June 7, 2017                            | February 6, 2017   April 6, 2017   April 17, 2017             | \$1,550 / \$1,295      |
| 2  | February 11, 2017 | June 11, 2017                           | March 20, 2017   May 10, 2017                                 | \$1,100 / \$950        |
| 3  | February 24, 2017 | June 24, 2017                           | February 6, 2017   April 24, 2017                             | \$1,506 / \$1,333      |
| 4  | February 28, 2017 | June 28, 2017                           | March 14, 2017   April 6, 2017   April 17, 2017               | \$1,335 / \$950        |
| 5  | March 2, 2017     | June 30, 2017                           | March 17, 2017 (COMPLIED)                                     | \$1,230 / \$1,150      |
| 6  | March 2, 2017     | June 30, 2017                           | February 22, 2017   May 10, 2017                              | \$1,550 / \$1,150      |
| 7  | March 2, 2017     | June 30, 2017                           | March 7, 2017   April 6, 2017                                 | \$1,400 / \$950        |
| 8  | March 2, 2017     | June 30, 2017                           | March 7, 2017   April 6, 2017                                 | \$1,400 / \$950        |
| 9  | March 7, 2017     | July 5, 2017                            | February 14, 2017   | \$600 / \$500          |
| 10 | March 20, 2017    | July 18, 2017                           | March 14, 2017   April 6, 2017   April 17, 2017               | \$1,335 / \$950        |
| 11 | March 20, 2017    | July 18, 2017                           | March 14, 2017   April 6, 2017   April 17, 2017               | \$1,335 / \$950        |
| 12 | March 24, 2017    | July 22, 2017                           | March 8, 2017   April 12, 2017                                | \$700/\$500            |
| 13 | March 27, 2017    | July 25, 2017                           | March 15, 2017  | \$1,400/\$825          |
| 14 | March 30, 2017    | July 28, 2017                           | February 6, 2017   April 24, 2017                             | \$1,889/\$1,834        |
| 15 | April 6, 2017     | August 4, 2017                          | February 6, 2017   April 24, 2017                             | \$1,889/\$1,834        |

# ATTACHMENT 2

City of Richmond Rent Program  
 Summary of Excess Rent Complaints  
 May 17, 2017 10:23 AM

| #  | Date Filed     | 120 Day Deadline for Final Board Action | Date Courtesy Compliance   Warning   Violation Letters Mailed | Current Rent/Base Rent |
|----|----------------|---|---|------------------------|
| 16 | April 8, 2017  | August 6, 2017                          | March 7, 2017   April 24, 2017                                | \$2,250/\$2,100        |
| 17 | April 14, 2017 | August 12, 2017                         | February 6, 2017   April 24, 2017                             | \$1,804/\$1,475        |
| 18 | April 15, 2017 | August 13, 2017                         | March 7, 2017   April 24, 2017                                | \$1,395/\$1,295        |
| 19 | April 26, 2017 | August 24, 2017                         | April 18, 2017  | \$1,100 / \$866        |
| 20 | May 1, 2017    | August 29, 2017                         | May 10, 2017  | \$1,150 / \$1,100      |
| 21 | May 1, 2017    | August 29, 2017                         | May 10, 2017  | \$1,150 / \$1,100      |
| 22 | May 16, 2017   | September 13, 2017                      | May 18, 2017  | \$872 / \$834          |

City of Richmond Rent Program  
 Summary Rent Adjustment Petitions  
 As of: May 17, 10:13 AM

## FORM SUBMISSION SUMMARY: RENT ADJUSTMENT PETITIONS

**Purpose:** Landlords and Tenants may file a petition for an increase or decrease in the Maximum Allowable Rent by completing the following form and submitting all required proof (RMC 11.100.070(c)). A hearing examiner will closely evaluate a request and the proof provided in accordance with Rent Board rules and regulations. **Total Petitions Submitted: 42. Total Petitions Filed by Tenants (Downward Rent Adjustment): 5. Filed by Landlords (Downward Rent Adjustment): 37.**

| #  | Date Filed        | Calendar Days Since Filing | Tenant or Landlord? | Reason for Filing<br>(Per online form categories and RMC 11.100.070(g))  |
|----|-------------------|----------------------------|---------------------|--|
| 1  | January 31, 2017  | 106                        | Landlord            | Increase or decrease in property taxes; The pattern of recent rent increases or decreases; 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. |
| 2  | January 31, 2017  | 106                        | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; Capital Improvements  |
| 3  | January 31, 2017  | 106                        | Landlord            | Increase or decrease in property taxes; The pattern of recent rent increases or decreases; Capital Improvements  |
| 4  | January 31, 2017  | 106                        | Landlord            | Increase or decrease in property taxes; The pattern of recent rent increases or decreases; Capital Improvements  |
| 5  | January 31, 2017  | 106                        | Landlord            | Increase or decrease in property taxes; The pattern of recent rent increases or decreases; Capital Improvements  |
| 6  | February 6, 2017  | 100                        | Landlord            | Other: Rent rollback   |
| 7  | February 8, 2017  | 98                         | Landlord            | The pattern of recent rent increases or decreases  |
| 8  | February 9, 2017  | 97                         | Landlord            | The pattern of recent rent increases or decreases  |
| 9  | February 12, 2017 | 94                         | Landlord            | The pattern of recent rent increases or decreases  |
| 10 | February 19, 2017 | 87                         | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increase or decrease.  |
| 11 | February 19, 2017 | 87                         | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increases or decreases   |
| 12 | February 20, 2017 | 86                         | Landlord            | Unavoidable increases or decreases in maintenance or operating expenses; Substantial deteriorations of the controlled rental units other than as a result of normal wear and tear; Capital improvements  |
| 13 | February 21, 2017 | 85                         | Landlord            | Unavoidable increases or decreases in maintenance or operating expenses; Substantial deteriorations of the controlled rental units other than as a result of normal wear and tear; Capital improvements  |
| 14 | February 24, 2017 | 82                         | Landlord            | Substantial deteriorations of the controlled rental unit other than as a result of normal wear and tear; Capital improvements  |
| 15 | February 26, 2017 | 80                         | Landlord            | Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent increases or decreases  |
| 16 | March 3, 2017     | 75                         | Landlord            | Substantial deterioration of the controlled rental unit other than a result of normal wear and tear  |

# ATTACHMENT 3

City of Richmond Rent Program  
 Summary Rent Adjustment Petitions  
 As of: May 17, 10:13 AM

| #  | Date Filed     | Calendar Days Since Filing | Tenant or Landlord? | Reason for Filing<br>(Per online form categories and RMC 11.100.070(g))  |
|----|----------------|----------------------------|---------------------|--|
| 17 | March 3, 2017  | 75                         | Landlord            | Substantial deterioration of the controlled rental unit other than a result of normal wear and tear  |
| 18 | March 3, 2017  | 75                         | Landlord            | Substantial deterioration of the controlled rental unit other than a result of normal wear and tear  |
| 19 | March 3, 2017  | 75                         | Landlord            | Unavoidable increases or decreases in maintenance or operating expenses  |
| 20 | March 3, 2017  | 75                         | Landlord            | Unavoidable increases or decreases in maintenance or operating expenses  |
| 21 | March 3, 2017  | 75                         | Tenant              | Requesting for relocation payment that haven't been paid in the amount of \$16,000   |
| 22 | March 8, 2017  | 70                         | Tenant              | The pattern of rent increase or decreases; Substantial deterioration of the controlled rental unit other than as a result of normal wear and tear; Capital improvements  |
| 23 | March 14, 2017 | 64                         | Landlord            | Increases or decreases in property taxes; The pattern of recent rent increases or decreases  |
| 24 | March 14, 2017 | 64                         | Landlord            | Increases or decreases in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increases or decreases   |
| 25 | March 14, 2017 | 64                         | Landlord            | Tenant is currently receiving a \$250 discount off of base rent, by serving as the building manager. I believe I have the right to terminate his manager position and add back the rent discount he currently receives. The add-back should not be treated as a rent increase. |
| 26 | March 20, 2017 | 58                         | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increases or decreases   |

# ATTACHMENT 3

City of Richmond Rent Program  
 Summary Rent Adjustment Petitions  
 As of: May 17, 10:13 AM

| #  | Date Filed     | Calendar Days Since Filing | Tenant or Landlord? | Reason for Filing<br>(Per online form categories and RMC 11.100.070(g))  |
|----|----------------|----------------------------|---------------------|--|
| 27 | April 11, 2017 | 36                         | Tenant              | Substantial deteriorations of the controlled rental unit other than as a result of normal wear and tear; Severe mold and moisture infestation; leaking water in living room windows causing uninhabitable living conditions; Certified letter was sent in January to the Property Manager at which time he sent out a crew to clean the mold from the walls; inspection of the unit was done and measurements for new windows taken; I was told that new windows would be installed to prevent further damage but that was in February 2017 until this point nothing has been done; last time I contacted Property Management in March 16th, 2017 I was told "Their going to have the windows next week"; It's been over a (3) months since first notification of said problems; I suffer from severe asthma and other allergies the bedroom has mold infestation! |
| 28 | April 12, 2017 | 35                         | Landlord            | The pattern of recent rent increases or decreases; At the time of 89yr old [name redacted] death, 05/09/2015, the \$800 per month rent had been allowed to remain at less than 50% of Fair Market Rent ( based on Sect 8 allowable rent schedule). As a result, Property Management Co (Bartels Prop) was subsequently fired. We respectfully request the rent be allowed to remain at \$1400 month. This amount of rent is still well below the Section 8 rent schedule.  |
| 29 | April 16, 2017 | 31                         | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increases or decreases.  |
| 30 | April 16, 2017 | 31                         | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increases or decreases.  |
| 31 | April 16, 2017 | 31                         | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increases or decreases.  |
| 32 | April 16, 2017 | 31                         | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increases or decreases.  |
| 33 | April 18, 2017 | 29                         | Landlord/PM         | Capital improvements; this property is a four-plex. The roof was replaced due to leaks. Also new fencing was installed around the property. There was no existing fencing around the complex. The fencing cost is 50% of the total bill as it is shared with the four-plex next door which is also under the same ownership.   |
| 34 | April 18, 2017 | 29                         | Landlord/PM         | Capital improvements; new front window installed in unit.  |
| 35 | April 18, 2017 | 29                         | Landlord/PM         | Capital improvements; This property is a four-plex. The roof was replaced due to leaks. Also new fencing was installed around the property. There was no existing fencing around the complex. The fencing cost is 50% of the total bill as it is shared with the four-plex next door which is also under the same ownership.   |
| 36 | April 21, 2017 | 26                         | Landlord /PM        | Capital improvements; Seismic retrofit. 4-Plex building had tuck under parking-- soft story construction. Project was planned by a licensed engineer who submitted plans to the City of Richmond Planning Dept. which approved same. Cost of engineering services (including directing contractor's work) was \$8,295. Contractor is specialist in EQ retrofitting. Included were plywood sheer walls over the preexisting interior garage walls, a new free standing sheer wall and foundation bolts. Cost of construction was \$52,511; total cost \$60,806.   |
| 37 | April 21, 2017 | 26                         | Landlord/PM         | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increases or decreases; Substantial deteriorations of the controlled rental unit other than as a result of normal wear and tear; 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; Capital Improvements.   |

# ATTACHMENT 3

City of Richmond Rent Program  
 Summary Rent Adjustment Petitions  
 As of: May 17, 10:13 AM

| #  | Date Filed     | Calendar Days Since Filing | Tenant or Landlord? | Reason for Filing<br>(Per online form categories and RMC 11.100.070(g))   |
|----|----------------|----------------------------|---------------------|---|
| 38 | April 26, 2017 | 21                         | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; 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; Capital Improvements   |
| 39 | May 3, 2017    | 14                         | Tenant              | Unavoidable increases or decreases in maintenance or operating expenses; Substantial deteriorations of the controlled rental unit other than as a result of normal wear and tear  |
| 40 | May 10, 2017   | 7                          | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increases or decreases  |
| 41 | May 10, 2017   | 7                          | Landlord            | Increase or decrease in property taxes; Unavoidable increases or decreases in maintenance or operating expenses; The pattern of recent rent increases or decreases.   |
| 42 | May 16, 2017   | 1                          | Tenant              | Failure on the part of the Landlord to provide adequate Housing Services or to comply substantially with applicable housing, health and safety codes; I been asking my landlord to fix these problems(bathroom and windows) for the past five months. I don't think it's fair that she has came out to fix things for the other tenants but will not fix things for me! |

**Comment**  
on  
**Fair Return Analysis**  
**Pursuant to the Zoning Application of**  
**2631 Durant St, Berkeley**

**Kenneth K. Baar, Ph.D**

Nov. 10, 2015

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This report was prepared at the request of the Berkeley Rent Stabilization Board. The opinions set forth in the report are those of the author and do not necessarily represent the opinions of the Board or its staff.

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## Summary

1. While the zoning ordinance provides for a determination of whether an applicant can make a fair return by maintaining the dwelling unit as a part of the rental housing market, it does not include a standard for determining what is a fair return.
2. In this case a "circular" type of fair return standard - rate of return on investment - was used, instead of the type of fair standard that has become most widely accepted as the most reasonable type of fair return standard - maintenance of net operating income.

While the concept of rate of return on investment makes sense for an investment analysis, its use in the context of a fair return analysis suffers from severe conceptual and methodological flaws.

- a) The fair rate of return on investment methodology is circular because the investor can determine what return is fair by setting the level of the investment (or even manipulate the outcome under such an approach),
- b) There is no standard rate that is "reasonable,"
- c) There is divergence about what "rate base" should be used in a rate of return analysis - the original investment, the original investment adjusted upward by the CPI increase since the time of the investment, or the original investment adjusted downward by depreciation.

In contrast, under the maintenance of net operating income standard, fair return is defined as net operating income as of a base year, adjusted by the increase in the Consumer Price Index since the base year. This type of standard has been adopted by the cities of Los Angeles, Santa Monica, and West Hollywood, as well as Berkeley. California appellate courts have repeatedly affirmed and positively commented on the use of this type of standard.

3. In this case, there are very large differences in projections of market rents by the Planning Staff and Rent Board Staff which lead to opposite conclusions by the Rent Board Staff and the Planning Staff about whether the current building could yield a fair return. No matter what type of fair return standard is used, this is a central issue. An independent appraiser should be engaged to provide an opinion on what the market rents of the current building would be assuming the projected renovation of the property. The Courts have indicated that fair return decisions must be based on expert opinion. Local agencies and applicants for fair return rent adjustments under rent stabilization ordinances have met this standard by using an appraiser. In this case, the opinions about current market rents are not based on market rent appraisals by appraisers (the only available appraisals were performed almost four years ago, before the exceptional surge in rents).
4. In advance of any future cases that raise fair return issues in the context of a zoning permit determination, a specific fair return standard should be adopted. Otherwise, the process will have to start with a "legislative" determination of what standard should be used, which will then be accompanied by a subjective "mix and match" process under that standard among the potential rates for which justifications can be proffered.

## The Author

The author has a Ph.D in urban planning and is an attorney. He has researched and published extensively on housing policy and real estate issues.

Over the past 30 years, he has served as a consultant to thirty California jurisdictions on issues related to rent stabilization. His articles on fair return issues have been cited in decisions of the California and New Jersey Supreme Courts and in numerous California Court of Appeal decisions. He has prepared fair return analyses in rent stabilization cases for seventeen California jurisdictions.

Also, he has served as a consultant to the World Bank and U.S. AID on policy issues in East European nations undergoing economic transition and on two occasions has been a visiting Fulbright professor in East Europe.

A copy of the author's resume is attached as Appendix A.

### **Appellate Court Opinions in Fair Return Cases Relying on the Testimony of Kenneth K. Baar**

*Rainbow Disposal Co., Inc. v. Mobilehome Park Rental Review Board*, 64 Cal. App.4th 1159 (1998)  
California Court of Appeal

*MHC Operating Limited Partnership v. City of San Jose*, 106 Cal. App.4th 204 (2003) California Court of Appeal

*Hillsboro Properties v. Public Utilities Commission*, 208 Cal. App. 4th 246 (2003) California Court of Appeal

*Berger Foundation v. City of Escondido*, 127 Cal. App.4th 1 (2005) California Court of Appeal

*Los Altos El Granada Investors v. City of Capitola*, 139 Cal.App.4th 629 as modified by 140 Cal.App.4th 135c (2006)

*Besaro v. City of Fremont*, 204 Cal. App.4th 345 (2012) California Court of Appeal

*Colony Cove Properties LLC v. City of Carson*, 220 Cal. App.4th 840 (2013) California Court of Appeal

### **Appellate Court Opinions Citing Analysis of Fair Return Issues in Law Review Articles authored by Kenneth Baar**

*Helmley v. Borough of Fort Lee*, 78 N.J. 200; 394 A.2d. 65 (1978) New Jersey Supreme Court, appeal dismissed, 440 U.S. 978, 99 S.Ct. 1782, 60 L.Ed. 2d. 237 (1979)

*Fisher v. City of Berkeley*, 37 Cal.3d. 644 (1984) California Supreme Court; affirmed, 475 U.S. 260, 106 S.Ct. 1045, 89 L.Ed.2d. 206 (1986)

*Oceanside Mobile Home Park Owners Association v. City of Oceanside*, 157 Cal.App.3d. 887 (1984) California Court of Appeal

*Mayer v. Jackson Township*, 103 N.J. 362; 511 A.2d. 589 (1986) New Jersey Supreme Court; cert. denied, 479 U.S. 1090, 107 S.Ct. 1300, 94 L.Ed. 2d. 155 (1987).

*Yee v. Mobilehome Park Rental Review Board*, 17 Cal. App. 4th 1097 (1993) California Court of Appeal

*Palomar Mobilehome Park v. City of San Marcos*, 16 Cal.App.4th 481 (1993) California Court of Appeal

*Kavanaugh v. Santa Monica Rent Control Board*, 16 Cal.4th. 761 (1997) California Supreme Court); cert. denied, 522 U.S. 1077, 118 S.Ct. 856, 139 L.Ed. 2d. 755 (1998)

*Rainbow Disposal Co., Inc. v. Mobilehome Park Rental Review Board*, 64 Cal.App.4th 1159 (1998) California Court of Appeal

*Quinn v. Rent Control Board of Peabody*, 45 Mass. App.Ct. 357, 698 N.E.2d.911 (1998, Massachusetts Court of Appeal)

*Galland v. City of Clovis*, 24 Cal.4th 1003 (2001) California Supreme Court; cert. denied, 534 U.S. 826, 122 S.Ct. 65 (2001)

*MHC Operating Limited Partnership v. City of San Jose*, 106 Cal. App.4th 204 (2003) California Court of Appeal

*Berger Foundation v. Escondido*, 127 Cal.App.4th 1 (2005) California Court of Appeal

*T.G. Oceanside L.P. v. City of Oceanside*, 156 Cal. App.4th. 1355 (2007) California Court of Appeal

## **I. Introduction**

This case involves an application for a permit to demolish an existing apartment building with 18 units and to construct a 56 unit building in its place.

In this case, one of the issues is whether the applicant can make a fair return on investment by maintaining the dwelling units as a part of the rental housing market. This report sets forth an opinion of how such an analysis should be conducted.

It is not the purpose of this report to consider or address other issues in this case.

Two types of issues emerge in considering a fair return claim.

1. What standard or methodology should be used in order to determine what is a fair return?
2. Whether the Applicant can obtain a fair return from the existing building?

## **II. An Appropriate Methodology for Making a Fair Return Determination**

All rent regulations contain fair return standards. Nearly all of the instances in which the fair return determinations have been made in regard to residential rental properties have been made in the context of determining allowable rents under a rent regulation.

Also, under ordinances which require mitigations associated with the discontinuances of existing uses (such a restrictions on mobilehome park and residential hotel closures) exceptions are provided where compulsion to continue the existing use will be a compulsion to operate a business that will not provide a fair return. Such provisions are a safety valve to insure that constitutional takings do not occur. Such a finding would be exceptional in light of the extraordinary increases in market rents that have occurred within the past few years.

While the zoning/planning ordinance that governs this case has a fair return standard, it does not define fair return or refer to any other definition of fair return.<sup>1</sup> Regulations adopted pursuant to the City's Rent Stabilization Ordinance contain a specific fair return standard. In this case, the planning staff used a type of fair return standard which is based on different

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<sup>1</sup> See Berkeley Municipal Code Sec. 23C.08.030.E.3.

concepts than the fair return standard promulgated under the City's rent regulation and most of the municipal rent regulations in the state.<sup>2</sup>

## 1. Judicial Doctrine Setting Forth Fair Return Criteria

Fair return is a constitutional law concept formulated by the Courts in order to protect owners from confiscatory takings. While legislative bodies may formulate fair return standards, the ultimate determination of whether a fair return has been permitted is subject to judicial review based on standards set forth in case law.

There is extensive judicial doctrine set forth in California appellate decisions regarding issues of fair return under rent regulation.<sup>3</sup> The early fair return cases (in the 1980's) commonly involved apartment rent regulations. Since the state mandated vacancy decontrol under apartment rent controls (the Costa-Hawkins Act) fair return applications have been rare under apartment rent controls. In contrast, there have been numerous appellate opinions involving fair return under mobilehome park space rent regulations (which are in effect in about one hundred California jurisdictions.) While the types of rental properties are physically distinct (apartment rental v mobilehome space land rental) the same fair return concepts are applied by the courts under both types of regulations.

As the courts have noted, the fair return issue is complex. In 1993, a California Court of Appeal commented about this complexity:

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.<sup>4</sup>

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<sup>2</sup> Approximately one hundred jurisdictions regulate mobilehome park space rents. A substantial portion of those ordinances contain maintenance of net operating income standards. Others list relevant factors in making a fair return determination without setting forth a formula; but maintenance of net operating standards are commonly used in the implementation of those standards.

<sup>3</sup> See Baar, "Fair Return under Mobilehome Park Space Rent Controls: Conceptual and Practical Approaches," 29 *Real Property Law Reporter* 333 (Sept. 2006, California Continuing Education of the Bar)

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

## 2. General Principles

This subsection discusses conceptual issues related to the use of alternate fair return standards and the basic judicial guidelines on the fair return issue in order to set forth the bases for this author's analysis.<sup>5</sup>

The courts have not required that a specific formula or standard be used in order to determine what rents provide a "fair return." (also labeled a "just and reasonable return.") Instead, the courts have repeatedly reiterated that: "a governmental entity may choose to regulate pursuant to any fairly constructed formula. The method of regulating prices is immaterial so long as the result achieved is constitutionally acceptable."<sup>6</sup> (bold added)

As the California courts have stated on several occasions:

"...there is no constitutionally required formula which must be utilized when government seeks to regulate the price charged for a good or service. [Citation.] ... [A] governmental entity may choose to regulate pursuant to any fairly constructed formula even though other formulas might allow for higher prices." (Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com. (1993) 16 Cal.App.4th 481, 487, italics added; Yee v. Mobilehome Park Rental Review Bd., supra, 17 Cal.App.4th 1097 at p. 1104; San Marcos Mobilehome Park Owners' Assn. v. City of San Marcos (1987) 192 Cal.App.3d 1492, 1498.) The United States Supreme Court held: "it is not the theory but the impact of the rate order which counts. If the total effect of the rate order cannot be said to be unjust and unreasonable, judicial inquiry [...] is at an end." (Federal Power Com'n v. Hope Natural Gas Co. (1944) 320 U.S. 591, 602.)<sup>7</sup>

The Courts have also repeatedly reiterated the principle that there is a "range" of rents that may be considered reasonable. One California Court of Appeal has explained:

There is a range of rents which can be charged, all of which could be characterized as allowing a "just and reasonable" return. (See Hutton Park Gardens v. Town Council (1976) 68 N.J. 543 [350 A.2d 1, 15] [the terms "just and reasonable" and "confiscatory" are not precise formulations]; Power Comm'n v. Pipeline Co. (1942) 316 U.S. 575, 585 [86 L.Ed. 1037, 1049, 62 S.Ct. 736, 743] [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.<sup>8</sup>

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<sup>5</sup> A more detailed discussion of fair return concepts is set forth in this author's article "Guidelines for Drafting Rent Laws: Lessons of a Decade," 35 Rutgers Law Review 721, 781-817 (1983).

<sup>6</sup> Carson Harbor Villages, Ltd. v. Carson Mobilehome Park Rent Review Board, 70 Cal. App. 4th 281, 290 (1999)

<sup>7</sup> Rainbow Disposal Co. v. Escondido Mobilehome Rent Review Bd. 64 Cal.App.4th 1159, 1172 (1998)

<sup>8</sup> San Marcos Mobilehome Park Owners Ass'n. V. City of San Marcos, 192 Cal.App.3d. 1492, 1502-1503 (1987)

While the courts have held that no specific formula is required and that a range of rents may be considered reasonable, they have set forth some criteria for fair return. Some of those guidelines have been largely theoretical. In *Kavanau v. Santa Monica Rent Control Board*, the California Supreme Court reiterated longstanding principles for fair return that have been set forth in utility cases and rent control fair return cases, stating that fair return:

1. "involves a balancing of the investor and consumer interests,"
2. should be a "return ... commensurate with returns on investments in other enterprises having corresponding risks,"
- and 3. "should be sufficient ... to attract capital."<sup>9</sup>

In *Galland v. Clovis*, the California Supreme Court held that the concept of "fair rate of return" is a legal term which refers to a "constitutional minimum", although the terminology is borrowed from finance and economics. The return must "allow [the] Owner to continue to operate successfully."

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.<sup>10</sup>

In *Fisher v. City of Berkeley* (1984), the State Supreme Court identified five types of fair return standards under rent controls: (1) cash flow/return on gross rent; (2) return on equity (cash investment); (3) return on value; (4) percentage net operating income; and (5) maintenance of net operating income.<sup>11</sup> The Court rejected the contention that a fair return on "value" was constitutionally required and concluded that this type of standard is "circular" in the context of a rent regulation, since value depends on the rent that is permitted.<sup>12</sup>

### 3. An Objective Standard of Fair Return

An exception to the theoretical nature of the judicial guidelines has been the establishment of a "floor" for fair return - the principal that net operating income may not be frozen. This principal was first set forth in a California Court of Appeal decision in 1983<sup>13</sup> and by the State

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<sup>9</sup> 16 Cal.4th 761, 772 (1997)

<sup>10</sup> 24 Cal.4th 1004, 1026 (2001)

<sup>11</sup> *Fisher v. City of Berkeley*, 37 Cal.3d. 644, 680 (1984)

<sup>12</sup> *Id.*

<sup>13</sup> *Cotati Alliance for Better Housing v. City of Cotati*, 148 Cal.App.3d 280,293 (1983)

Supreme Court in 1984, in *Fisher v. City of Berkeley*<sup>14</sup> and has been adhered to by the Courts since that time.

This direction is critical. It supports the use of an MNOI standard because the MNOI standard compares prior levels of net operating income<sup>15</sup> with current levels. Under this standard a determination is made as to whether net operating income has decreased, remained frozen, or by what percentage it has increased since a base period. In contrast, the rate of return on investment standard only considers the current level of net operating income without any comparison of base year and current year net operating income.

In regard to a claim that a rate of return on investment standard should be used when it justifies a higher rent than an MNOI standard, the courts have rejected the view that this fact in itself demonstrates that the MNOI standard is not providing a fair return.<sup>16</sup>

#### 4. The Maintenance of Net Operating Income (MNOI) Standard

In California the maintenance of net operating income (MNOI) standard is the most widely used fair return standard. This standard is in effect under the apartment rent regulations of Los Angeles, Santa Monica, West Hollywood, and East Palo Alto, as well as Berkeley and is widely used among the ninety jurisdictions that have adopted mobilehome park space rent regulations. A fair rate of return on investment standard is not used under any of the apartment rent control ordinances and but is used under a small portion of the mobilehome park space rent stabilization ordinances.<sup>17</sup> The other three standards that are mentioned in the *Fisher* opinion have not been used or have only rarely been used.<sup>18</sup>

Under an MNOI standard owners are permitted rent increases which cover increases in operating costs and provide for an increase in net operating income based on the increase in the CPI. For example, if the net operating income was \$100,000 in the base year and the Consumer Price Index (CPI) has increased by 70% since the base year, under a standard which provides for indexing the net operating income at 100% of the rate of increase in the CPI, the current fair net operating income would be \$170,000. (Jurisdictions with MNOI standards provide for indexing base period net operating by varying percentages of the percentage

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<sup>14</sup> *Fisher v. City of Berkeley*, 37 Cal.3d. 644, 681 (1984)

<sup>15</sup> Net operating income is equal to gross income minus operating expenses. Mortgage interest is not considered to be an operating expense.

<sup>16</sup> *Rainbow Disposal v. Mobilehome Park Rental Review Board*, 64 Cal.App.4th 1159,1172 (1998, California Court of Appeals)

<sup>17</sup> Commonly the terms "return on investment" are set forth in rent ordinances; however, a maintenance of net operating income standard is used to make the fair return determination.

<sup>18</sup> These conclusions are based on this author's observations in the course of over twenty years of preparing fair return reports for cities with mobilehome rent stabilization, rather than a systematic count.

increase in the Consumer Price Index, ranging from 40% to 100%. Berkeley uses for 40%. All of these indexing levels have been upheld by the Courts.)

This formula provides for reasonable growth in net operating income, which is the portion of rental income that is available to cover increases in debt service.

The rationale for an MNOI approach is that it provides a right to rent increases that cover increases in operating expenses and provide for growth in net operating income, and therefore, 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.

Therefore, rents are regulated depending on increases in operating expenses and the inflation rate (Consumer Price Index). 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. By permitting growth in net operating income, the standard makes room for increasing debt service and finance costs.

Furthermore, because value is a function (multiple) of net operating income, the MNOI standard, with indexing based on increases in the CPI, leads to appreciation in the value of a property, which may be converted into a capital gain. This approach meets the twin objectives of "protecting" tenants from "excessive increases" and providing regulated owners with a "fair return on investment."

In *Rainbow Disposal v. Mobilehome Park Rental Review Board* (1995) the Court of Appeal concluded that the MNOI formula is a "fairly constructed formula" which provides a "just and reasonable" return on ... investment."

[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 Baar's 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.<sup>19</sup>

Prior to *Rainbow*, in several cases California appellate courts approved the MNOI standard (*Oceanside Mobilehome Park Owners' Ass'n v. City Oceanside*<sup>20</sup> and *Baker v. City of Santa Monica*,<sup>21</sup>) 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.<sup>22</sup>

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<sup>19</sup> 64 Cal. App.4th 1159, 1172 (1998)

<sup>20</sup> 157 Cal.App.3d.887 (1984).

<sup>21</sup> 181 Cal.App.3d. 972 (1986).

<sup>22</sup> 157 Cal.App.3d.887, 902-905 (1984).

In 1993, the Court of Appeal commented: "The maintenance of net operating income approach has been praised by commentators for both its fairness and ease of administration.

...<sup>23</sup>

In a recent case, *Colony Cove v. City of Carson*, a Court of Appeal explained the rationale for an MNOI standard.

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." (*Oceanside Mobilehome Park Owners' Assn. v. City of Oceanside*, supra, 157 Cal.App.3d at pp. 899-900, quoting *Cotati Alliance for Better Housing v. City of Cotati*, supra, 148 Cal.App.3d at p. 287.) ....

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.[]" (*Oceanside Mobilehome Park Owners' Assn. v. City of Oceanside*, supra, 157 Cal.App.3d at p. 903.) Instead, it "permits park owners to obtain a just and [\*\*\*60] reasonable return under general marketing conditions in any given year" and "reflect[s]

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<sup>23</sup> *Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com.*, 16 Cal.App.4th 481, 486 (1993)

the tenant's interest by giving the park owner an incentive to incur all reasonable expenses for maintenance and services." (Id. at pp. 902-903.)<sup>24</sup>

One weakness of the MNOI standard is that it may lock an owner into very low rents that do not reflect market conditions, in cases in which the base period rent was exceptionally low. This occurs because the current fair net operating income is a function of the base period income.<sup>25</sup> However, this shortcoming has been addressed by authorizing adjustments of base period rental income for the purposes of the maintenance of net operating income analysis 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.)

### 5. Rate of Return on Investment Standards

The Planning staff has used a rate of return on investment methodology to determine whether the potential rents from the property would provide a fair return.

When rate of return on investment formulas have been used in the context of rent regulations, the most common formula has been:

$$\text{FAIR NET OPERATING INCOME} = X\% * \text{INVESTMENT}$$

("X" constitutes the rate of return)

$$\text{FAIR RENT} = \text{OPERATING EXPENSES} + \text{FAIR NET OPERATING INCOME}$$

Investment is defined as the total investment (purchase price + improvements) rather than only as the cash investment (total investment minus mortgage borrowing), and the return is the net operating income, rather than only the cash flow (net operating income minus mortgage payments).<sup>26</sup>

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<sup>24</sup> 220 Cal. App. 4th 849, 869-870 (2013)

<sup>25</sup> See e.g. *Vega v. City of West Hollywood*, 223 Cal.App.3d 1342 (1990) and *Concord Communities v. City of Concord*, 91 Cal. App.4th 1407 (2001)

<sup>26</sup> In some jurisdictions a fair return on cash 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). This type of standard has not been proposed in this case.

In the ZAB's decision a determination was made that market rents would not be adequate to provide a fair return on the investment in the property, taking into account the projected costs of undertaking an extensive overhaul of the building when measuring the investment.

### ***Conceptual Issues Associated with the Use of a Rate of Return Analysis under a Price (Rent) Regulation***

#### **Circularity**

Rate of return on investment is a standard method of investors in evaluating their investments and intuitively appears to be a reasonable measure of when a property yields a fair return. However, in the context of a fair return determination, the use of a fair rate of return on investment standard poses fundamental conceptual shortcomings.

A fair rate of return on investment standard works in a circular manner, especially in the case of a recent investor. In the market place, investment is determined by the expected returns. If the allowable returns under a price regulation are set by the investment, the process of determining what is a fair return becomes circular, with the investment (and, therefore, the investor) determining what return will be fair.

A leading utility text notes that the fallacies and circularity of using the purchase price (transfer cost) as the measure of investment in order to calculate fair return, in a regulatory context.

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

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

This fallacy has been generally overlooked in rent control cases. However, federal courts in New York have concluded that the return on investment approach does not make sense in the context of land use controls and rent regulation. They have noted that under the return on investment approach, the "regulated" investor can, in fact, regulate the allowable return 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]<sup>27</sup>

In a subsequent case, the New York Federal Court indicated that the same logic is applicable in the case of rent regulations.<sup>28</sup>

In a recent case, *Colony Cove vs. City of Carson*, a California Court of Appeal noted the "problematic" nature of a rate of return on investment standard.

A return on investment standard may also be problematic to administer, because an owner's equity can be greatly affected by individual differences in methods and costs of financing, and because owners who inherit rental property or receive it through a gift have no cash investment against which to measure their return. (*Cotati Alliance for Better Housing v. City of Cotati*, supra, at p.289.)

In *Fisher v. City of Berkeley*, the California Supreme Court noted that the "mechanical" application of a return on investment standard could produce "confiscatory results in some ...cases" and alternatively could provide for "windfall" returns of 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 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.<sup>29</sup>

On the other hand, if a "prudent" investor standard is used to try to limit what size investments will be considered and that standard only allows for a fair return on a "prudent" investment, one that is covered by the current rents, no increase can ever be justified by the standard.

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<sup>27</sup> *Park Avenue Tower Associates v. City of New York*, 746 F.2d. 135, 140 (1984).

<sup>28</sup> *Rent Stabilization Association v. Dinkins*, 805 F.Supp. 159, 163 (1992).

<sup>29</sup> 37 Cal.3d. 644, 691 (1984)

One Court of Appeal concluded that the argument that a purchase cost may be viewed as high (imprudent) is a "Catch-22." 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".<sup>30</sup>

This type of split of authority is not an accident. It reflects the inevitable appearance of the two sides of a circular concept. On the one hand, the rate of return on investment standard can provide windfall returns to recent investors and provides an incentive to invest as much as possible for a property if the rate of return which is deemed fair is attractive relative to the rates that may be obtained on other alternative investments.

To place the foregoing discussion of the circularity issue in perspective, it should be noted that the Courts have concluded that a return on value standard is circular, since the potential rent determines the value which under a fair return on value is in turn used to determine the fair rent. While the Courts have stated that there are problems with the rate of return on investment formula, they have not stated that this type of formula cannot be used. However, its deficiencies led to the preference of the maintenance of net operating income standard. In fact, the rate of return on investment standard is a "close cousin" of the rate of return on investment standard, because the investment determines the allowable rent, which in turn determines how purchasers will be willing to invest in the property.

### **Subjectivity and Differences in How to Measure Fair Rate of Return under a Rate of Return on Investment Standard**

Apart from the circularity issues associated with the use of a rate of return on investment standard, there are substantial issues associated with the calculation of the investment (the rate base) and the determination of an appropriate rate.

In fact, rates of return vary substantially among properties especially in times of substantial inflation in property values. Therefore, the net operating income (and, therefore, the rent) that will yield a fair return to a 1980 purchaser might be a fraction of the rent required to provide the same rate of return to a recent purchaser.

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

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

adjudicatory process the fair return determination can turn into a mix and match process (among the alternate measures of investment and of a fair rate) aimed at obtaining a desired result.

**Selecting a Rate: "witches' brews of statistical elaboration and manipulation...."**

The selection of an appropriate rate presents another set of problems. One commentary characterizes expert presentations on which particular rate is fair in utility rate cases as "witches brews".

"... 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.<sup>31</sup>

In mobilehome park rent stabilization fair return cases projections by expert witnesses 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 and experts on behalf of cities and/or residents have contended that a fair rate is equal to the prevailing capitalization rate, about 5 to 7%. 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%.

#### **Measuring the Investment (The Rate Base)**

Large variations in the outcome of a fair return calculation can also be generated by alternate choices in regard to the measure of the investment (rate base). One principal issue within the return on investment debate has been over whether original investment should be used as a rate base or whether that investment should be adjusted for inflation. 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. The problem with the return on investment approach is that in periods of ordinary and/or extraordinary inflation in the prices of real property, the fair return becomes a function of the length of ownership. As a result, the fair return rent for otherwise comparable apartment buildings will vary substantially based on the purchase date of the building.

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<sup>31</sup> Shepard and Gies, *Utility Regulation, New Directions in Theory and Policy*, 242-243 (1966, New York, Random House)

Some courts have held that the investment should be adjusted to reflect inflation since the time the property was purchased. In *Cotati Alliance for Better Housing v. City of Cotati*, (1983) 148 Cal.App.3d 280, 289 a California Court of Appeal 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." In a case involving apartment rent controls, the New Jersey Supreme Court stated "although increasing an investment base to adjust for inflation is not a constitutional imperative, it would be an almost complete answer to a claim of confiscation. ...." *Mayer v. Jackson Township*, 511 A. 2d at 596, n.7 (1986).

However, in other instances California appellate courts have upheld the use of a formula 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, in which the Court based on the following reasoning:

[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. 4<sup>th</sup> at 488)

This type of debate is not new. In the case of utility regulation, there has been a long running debate over whether to use historical cost or reproduction cost as the rate base.

The rate of return on investment concept comes from utility price regulation, however, the context of mobilehome space rent regulations differs. In the case of utilities investments, the investment (the rate base) is a measure of cost of the production and replacement of facilities that service the consumers. These investments provide the basis for a reasonable rate base. In the case of apartments the use of investment as a rate basis is circular because most of the investment is in the ownership of land which provides the right to collect the rents (return) from the rental units.

The table on the following page illustrates how the wide range of possible rate bases and possible rates used in rate of return fair return analyses can lead to vastly diverging results.

**Alternate Outcomes under Rate of Return on Investment Standards**  
**(Rate = NOI/Investment)**

| <b>Investment<br/>(Rate Base)</b>  | <b>Fair Rate</b>   | <b>Fair Net Operating<br/>Income<br/>(investment x fair rate)</b> |
|--|--|---|
| <b>\$2,000,000</b><br><b>original investment</b><br>(e.g. 40 apartments *<br>\$50,000/space) | 5%<br>capitalization rate<br>(noi/purchase price ratio new<br>purchases)                       | <b>\$100,000</b>  |
|  | 7%   | <b>\$140,000</b>  |
|  | 12%<br>fair rate sometimes estimated by<br>economist or appraiser based on<br>estimate of risk | <b>\$240,000</b>  |
| <b>\$1,200,000</b><br>original investment<br>minus depreciation of<br>improvements           | 5%   | <b>\$60,000</b>   |
|  | 7%   | <b>\$84,000</b>   |
|  | 12%  | <b>\$144,000</b>  |
| <b>\$3,000,000</b><br>original investment<br>adjusted by CPI                                 | 5%   | <b>\$150,000</b>  |
|  | 7%   | <b>\$210,000</b>  |
|  | 12%  | <b>\$360,000</b>  |

## **The Problem with a Rate of Return on Investment Standard when a More Profitable (Higher Density) Land Use is Available**

Apart from the foregoing problems with the use of a rate of return on investment standard to determine fair return on a residential rental, another problem emerges when a more profitable land use is available. In such instances, the land value and therefore, the investment in the property becomes a function of the value of the higher use, while the fair return concept is hinged to the issue of whether the current use provides a fair return.

Under these circumstances, whether or not the return from the current use of a property yields a fair return on investment will be largely dependent on the gap between the density under the current use and the possible density pursuant to a higher density. For example, if a property has eight apartment units, but the allowable zoning will permit 50 apartment units, there is a high certainty that the yield from the eight units will not provide a high return on the investment (land value) generated by the potential use for 100 units. Buildings that are identical in terms of rents, operating expenses, and physical condition, may yield vastly differing rates of return on investment, because the amount of the investments differ due to greatly varying development potentials based on zoning differences.

Recently a Court of Appeal considered an extreme example of the difference between current use value and a higher value in an alternate use in a case in which a mobilehome park owner contested the allowable rent level under the city's rent regulation on the basis that the return was unreasonably low compared to the potential return if the land was cleared of the mobilehome park and redeveloped.

It is clear from the written decision that the hearing officer did not fail to consider evidence that the property might be more profitable if used for another purpose; she simply did not believe that a park owner earning a fair return on its investment (as Besaro admittedly was) could properly rely on some hypothetical higher use of the property as a basis for increasing that return outside the ordinary rent control provisions. This was a reasonable conclusion. A property's potential to generate more income if converted into single family homes or some other type of housing is not particularly useful in determining the fair rent for spaces so long as it is used as a mobile home park.<sup>32</sup>

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<sup>32</sup> *Besaro v. City of Fremont*, 204 Cal. App. 4th 345, 356 (2012)

## Prognosis

In this case, in the hearings before the ZAB, issues were not raised about the methodology (formula) used to determine fair return. Instead, the discussion and disagreement was limited to the question of what numbers should be plugged into a fair rate of return on investment analysis.

However, if the fair return issue is considered in future reviews of land conversions to more dense development and a rate of return on investment standard is used to measure whether the current use yields a fair return, the problems that are inherent in such an approach will become central.

In light of the complexity and the potential for subjectivity associated with making a fair return determination (selection of standard, selection of rates etc.), a fair return formula and procedure should be in place in advance of any future cases. Otherwise, the adjudication of the fair return issue will become a mixture of a debate about what the standard should be used and what specific measures should be used within the standard.

In 2006, in an article in a publication of the California Continuing Education of the Bar, this author wrote the following about the outcomes of standards without formulas:

The approach of adopting a list of factors without a formula insulates an ordinance from facial challenges on the ground that its specific fair return formula does not permit a fair return, because it gives the adjudicating body the latitude to choose virtually any approach. However, at the same time, it turns the adjudication of fair return petitions into "legislative" hearings over how fair return should be measured with a full-scale debate over the pros and cons of alternate formulas, (unless the administrative body has clearly established a particular standard as a matter of practice.) In the end, the hearing body may select a result and then select the approach which will justify that result.<sup>33</sup>

In one case involving fair return under rent control, a California Court of Appeal concluded that "no specific formula should be developed"

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<sup>33</sup> Baar, "Fair Return under Mobilehome Park Space Rent Controls, Conceptual and Practical Approaches", 29 *Real Property Law Reporter* 333, 335 (Sept. 2006, California Continuing Education of the Bar)

...the Board, in making general rent adjustments and acting upon petitions for individual increases, must consider a variety of factors, some of which may be personal or individual to a particular landlord or rental property.<sup>34</sup>

However, other appellate courts have been critical of such an approach. The New Jersey Supreme has commented that:

It is inappropriate for a community to adopt a rent control ordinance without definitive standards" and that "rent control ordinances should set forth standards and criteria by which the parties, the local rent control agency, and reviewing tribunals can be guided in determining adequacy of returns actually received under the ordinance."<sup>35</sup>

Another California Court of Appeal followed precedent upholding standards that do not contain a specific formula, but noted the problems associated with such an approach.

Application of the [substantial evidence] test [for the review of administrative decisions] inherently requires that the reviewing court first determine the question, "Substantial evidence of what?" In the usual situation, the "what" is to be found in the statute empowering the agency, sometimes as expanded by agency regulations. In the case at bench however, the ... Ordinance does not set forth the "what." Rather it merely lists factors to be considered by the Board without specifying their relative impact.<sup>36</sup>

In this case, the fair return review has an additional layer of uncertainty because the fair return claim was made after the interior of the property had been substantially demolished, rather than before. One result has been a factual disagreement over an essential issue in regards to the rent projections – the number of bedrooms in each unit. One requirement should be that fair return claims be submitted before any changes to the building that would impede a determination of what rents could be obtained. In this case, any market rent appraisal should be based on the assumption that a reconstruction of the building would be designed in a fashion that would maximize potential rental income.

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<sup>34</sup> *Cotati Alliance for Better Housing v. City of Cotati*, 148 Cal.App.3d 280, 294 (1983)

<sup>35</sup> *Mayer v. Jackson Township*, 511 A.2d 589, 59 (1986))

<sup>36</sup> *Yee v. Mobilhome Park Rental Review Bd.* 17 Cal.App.4th 1097, 1106. (1993)

### III. A Fair Return Determination in this Case

This report does not include an opinion about whether the property as an 18 unit building could provide a fair return. However, some comments are made in regard to such an analysis.

In this particular case, the potential circularity associated with the use of a rate of return analysis is not as severe as in the typical case because two-thirds of the investment calculation for the purpose of the fair return analysis actually reflects the costs of overhauling the property rather than the applicant's purchase cost for the building which in reality was an investment in the land. The investment in the land is an investment in the potential rent or market value that can be realized either through the present use or a future use that will be permitted.

#### Projection of Potential Rental Income in the Case

In this case, whether a fair rate of return on investment or a maintenance of net operating income is used, a projection of potential market rents is central to the outcome of a determination on the fair return issue and there are vast differences between the projections by the Planning Staff and the Rent Board in regard to this issue.

Appraisals of market value or market involve a fair amount of subjectivity which can lead to widely varying results. In one case a poetic New Jersey judge commented:

Two real estate experts using one chart  
Have opinions of value millions apart  
Since both are correct, it would seem to impart  
That real estate appraisal is a miraculous art<sup>37</sup>

In this case, the differences between the annual gross rent projections of the Planning Staff and the Rent Board (\$344,760 v. \$426,010) lead to opposite outcomes of the fair return analysis.<sup>38</sup>

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<sup>37</sup> *Helmley v. Borough of Fort Lee*, No. L-13-719-78 at 32, n.12 (N.J. Super Ct. L. Div, Oct. 7, 1978) quoted in Baar, "Guidelines for Drafting Rent Control Laws: Lessons of a Decade", 35 *Rutgers Law Review* 723, 798, n. 296 (1983).

<sup>38</sup> See Staff Report, Zoning Adjustments Board, June 25, 2015, p.12 and Memo from Jay Kelekian, Rent Stabilization Board to: Immanuel Bereket, Planning and Development Dept., Sept. 16, 2015.

In this case, there are two appraisals of market rents which were obtained by the applicant. However, they were obtained in 2012, a period preceding the enormous surge in market rents of the past few years.

In cases under mobilehome park rent stabilization in which market rents are an issue, typically the City has hired its own appraiser after a park owner has submitted an appraisal report of market rents.<sup>39</sup> The Courts have held that a fair return finding must be based on expert opinion.<sup>40</sup>

### The Use of a Maintenance of Net Operating Income (MNOI) Approach

#### Feasibility

The use of a maintenance of net operating income (MNOI) approach would be feasible and reasonable. Base Year (1982) rent levels are recorded in the registration forms that were submitted to the Rent Stabilization Board. Operating costs studies project average apartment operating expenses at that time. Therefore, base period net operating income can be estimated. If 100% of CPI indexing were applied in measuring fair return, a fair return would be the base year amount adjusted by the 250% increase in the CPI that has occurred since that date.<sup>41</sup>

As a practical matter, the extensive renovation cost when capitalized, in itself, will require a substantial amount of rent and the calculation of the return on such an investment under an MNOI standard is comparable to the calculation that would be made under a rate of return on investment standard.

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<sup>39</sup> Market rent issues have emerged in cases in which there is a claim that base rents should be adjusted in a maintenance of net operating income analysis because they do not reflect market conditions.

<sup>40</sup> *Whispering Pines Mobile Home Park, Ltd. V. City of Scotts Valley*, 180 Cal.App.3d 152, 160 (1986) ("We consider it a matter of expert opinion what rate of return on a mobilehome park is fair.")

<sup>41</sup> CPI data. The Courts have upheld maintenance of net operating income standards which provide for indexing net operating income by 40% of the percentage increase in the CPI since the base year.

### **Determination of Fair Rate if a Rate of Return on Investment Standard is Used.**

In this case, while information from other apartment building sales is considered, there is a lack of "systematic" data projecting prevailing capitalization rates, which are in turn used to project a fair rate of return.

The two appraisals obtained by building owner had substantially differing projected capitalization rates of 7% and 5.5%.<sup>42</sup> This difference in itself, translates into a difference of \$55,962 (1.5% of \$3,730,818) in the projection of gross rents needed to provide a fair return under a fair rate of return on investment standard. On a monthly per unit basis the fair rent difference is \$259 ( $\$55,962 / (18 \text{ units} \times 12 \text{ months})$ ).

A widely used real estate data service provides projections of average capitalization rates for classes of properties that are selected (e.g. by location, number of apartment units, age). Real estate industry reports include data on average capitalization rates for apartment buildings within metropolitan areas. Such data should be considered in a projection of a fair rate of return.

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<sup>42</sup> See Appraisal Reports by Yovino Young (Berkeley), p6, April 13, 2012 and Velco Appraisal Services (Walnut Creek), p.57, April 2, 2012. (Not included in administrative record.)

