AGENDA ITEM REQUEST FORM

Department: Rent Program **Department Head:** Nicolas Traylor **Phone:** 620-6564

Meeting Date: February 21, 2018 **Final Decision Date Deadline:** February 21, 2018

STATEMENT OF THE ISSUE: Section 11.100.070 of the Fair Rent, Just Cause for Eviction, and Homeowner Protection Ordinance ("Rent Ordinance") provides that "landlords have a right to a reasonable return on their investment" or right to a reasonable or fair return. The primarily vehicle for achieving a "fair return" is the Annual General Adjustment, which, when applied to the Base Rent creates the Maximum Allow Rent level. When a landlord is not achieving a fair return by way of the Annual General Adjustment, the Ordinance allows landlords to petition the Board to increase the rent above the Maximum Allowable Rent. At their meeting on December 20, 2017, the Board directed staff to prepare regulations utilizing the Maintenance of Net Operating Income (MNOI) standard for the Board's consideration. In partnership with Dr. Kenneth Baar, Rent Program staff members have prepared the Fair Return (Maintenance of Net Operating Income) regulation for the Rent Board's consideration. Part 2 of the Fair Return regulations, which will include the Capital Improvement and Historically Low Rent regulations are to be brought to the Board for their review at the February 28, 2018 Special Board meeting.

INDICATE APPROPRIATE BODY

☐ **City Council** ☐ **Redevelopment Agency** ☐ **Housing Authority** ☐ **Surplus Property Authority** ☐ **Joint Powers Financing Authority**

☐ **Finance Standing Committee** ☐ **Public Safety Public Services Standing Committee** ☐ **Local Reuse Authority** ☒ **Other: Rent Board**

ITEM

☐ **Presentation/Proclamation/Commendation (3-Minute Time Limit)**

☐ **Public Hearing** ☐ **Regulation** ☒ **Other: STUDY AND ACTION SESSION**

☐ **Contract/Agreement** ☐ **Rent Board As Whole**

☐ **Grant Application/Acceptance** ☐ **Claims Filed Against City of Richmond**

☐ **Resolution** ☐ **Video/PowerPoint Presentation** (contact KCRT @ 620.6759)

RECOMMENDED ACTION: Receive Proposed Draft Maintenance of Net Operating Income (MNOI) Fair Return Regulation (Chapter 9) (Nicolas Traylor/Michael Roush 620-6564).

AGENDA ITEM NO:

H-1.

AGENDA REPORT

DATE: February 21, 2018

TO: Chair Gray and Members of the Rent Board

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

SUBJECT: PROPOSED DRAFT MAINTENANCE OF NET OPERATING INCOME (MNOI) FAIR RETURN REGULATION (Chapter 9)

STATEMENT OF THE ISSUE:

Section 11.100.070 of the Fair Rent, Just Cause for Eviction, and Homeowner Protection Ordinance ("Rent Ordinance") provides that "landlords have a right to a reasonable return on their investment" or right to a reasonable or fair return. The primarily vehicle for achieving a "fair return" is the Annual General Adjustment, which, when applied to the Base Rent creates the Maximum Allow Rent level. When a landlord is not achieving a fair return by way of the Annual General Adjustment, the Ordinance allows landlords to petition the Board to increase the rent above the Maximum Allowable Rent. At their meeting on December 20, 2017, the Board directed staff to prepare regulations utilizing the Maintenance of Net Operating Income (MNOI) standard for the Board's consideration.

In partnership with Dr. Kenneth Baar, Rent Program staff members have prepared the Fair Return (Maintenance of Net Operating Income) regulation for the Rent Board's consideration. Part 2 of the Fair Return regulations, which will include the Capital Improvement and Historically Low Rent regulations are to be brought to the Board for their review at the February 28, 2018 Special Board meeting.

RECOMMENDED ACTION:

Receive Proposed Draft Maintenance of Net Operating Income (MNOI) Fair Return Regulation (Chapter 9) (Nicolas Traylor/Michael Roush 620-6564).

FISCAL IMPACT:

The cost to administer the Rent Adjustment/Fair Return Petition process is accounted for in the Fiscal Year 2017-18 Rent Program Budget. The proposed draft regulations do not provide for a filing fee at this time, but allows the Rent Board to establish such a fee in the future if deemed appropriate.

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 provides for the right to a reasonable return and tasks the Rent Board with promulgating Fair Return regulations.

The Maintenance of Net Operating Income regulation establishes standards for allowing an increase above the Maximum Allowable Rent level in cases where the landlord is not receiving a fair return. "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. In future Board meetings, Board members will be tasked with reviewing and adopting two additional Fair Return regulations: a capital improvement regulation and historically low rent regulation.

Overview of Maintenance of Net Operating Income (MNOI) Regulation
The table on the following page is a brief summary of the proposed MNOI regulation (Attachment 1).

Fair Return Standard (Chapter 9)		
Regulation Number	Title	Purpose
905(A) (1)	Presumption of Fair Base Year	Establishes that the Net operating income received by the Landlord in the Base Year provided a Fair Return
905(A) (2)	Fair Return	Establishes that a landlord has the right to obtain a net operating income equal to the base year NOI adjusted by X% of the percentage in the CPI since the Base Year
905 (A) (3) and 905 (A) (4)	Base Year and Current Year	Regulation that establishes the Base and current years for MNOI standard
905 (A) (5)	Adjustment of Base Year Net Operating Income	This regulation allows Landlords to rebut the assumption that the Base Year provided a Fair Return-either due to exceptional expense circumstances in the Base Year
905 (A) (6)	Calculation of Net Operating Income	This regulation provides the formula for calculating net operating income and defines Gross Rental Income and Operating Expenses (maintenance/operational costs, utility costs, real property taxes, licenses and fees, landlord-performed labor, legal expense and the amortized costs of capital improvements)

Regulation Number	Title	Purpose
905 (A) (6) (a) 905 (A) (6) (b) 905 (A) (6) (c)	Amortization of Capital Improvements Impact of Vacancy Rent Increases on Capital Improvements Increases Types of Operating Expenses Not Included in Fair Return Calculation	905 (A) (6) (a) viii defines how costs are amortized using an interest allowance. (A) (6) (b) (x) requires that capital improvement increases be terminated for tenancies which have had their rents reset through vacancy rent increases. 905 (A) (6) (c) describes what types of operating expenses shall not be included in the fair return calculation
905 (A) (6) (d)	Adjustment to Operating Expenses	Base year and/or current year operating expenses may be averaged in cases where there are exceptional costs in either the base or current year. This is done in order to establish cost for expenses that most reasonably serves the objectives of obtaining a reasonable comparison of the bas year and current year, while providing a Fair Return
905 (A) (6) (e)	Projections of Base Year Operating Expenses in the Absence of Actual Data	Standard that establishes how to calculate base year expense data in cases where there is an absence of actual base year expense data
905 (A) 7	Allocation of Rent Increases	Defines how authorized Fair Return rent increases would be allocated among rental units/building

Regulation Number	Title	Purpose
905 (A) (8)	Conditional Rent Adjustments for Proposed Capital Improvements	Allows a Landlord to petition for an upward rent adjustment based on anticipated future expense for capital improvements and provides for conditions for authorization and implementation of those rent increases
905 (A) 9	Impact of Recent Vacancy Rent Increases Eligibility for Capital Improvement Increase	Establishes that any unit that has received a vacancy rent increase within two years prior to the fair return application shall be ineligible for any rent increase based on the cost of the proposed capital improvement
905 (A) (10)	Limits to Annual Rent Adjustments Based on Maintenance of Net Operating Income Standard	The purpose of this regulation is to protect tenants from substantial rent increases, by placing a limit on the amount that can be charged for a Fair Return/MNOI rent increase
905 (A) (11)	Constitutional Right to A Fair Return	Provides that no section of the (proposed) Fair Return regulations shall be applied to prohibit the Board from granting a Fair Return increase

A copy of the draft Fair Return regulations for the Board's consideration were posted on the Rent Program website on February 14, 2018 and a listserv message will be 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.

Proposed Timeline and Next Steps

Proposed Date	Event
February 21, 2018 – Regular Rent Board Meeting #1	Rent Board considers substantive rent adjustment, vacancy rent adjustment and rent registration regulations for adoption and receives MNOI Fair Return regulations
February 28, 2018- Special Rent Board Meeting #2	Rent Board considers MNOI Fair Return regulations for adoption and receives Capital Improvement and Historically Low Rent Fair Return regulations

DOCUMENTS ATTACHED:

Attachment 1 – DRAFT Fair Return (MNOI) Regulations (Chapter 9, Regulation 905)

Attachment 2 – Memo on Fair Return Regulation by Ken Baar

ITEM H-1

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 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 maybe 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.

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 <u>not</u> 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**.

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

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 been 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.

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)

AMORTIZED COST TABLE (EXAMPLE)

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**

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 <u>not</u> 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.

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;

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 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 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.

M E M O R A N D U M

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

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.

	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.

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).

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)

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)

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)