“FAIR RETURN” AND MAINTENANCE OF NET OPERATING INCOME (MNOI) OVERVIEW

CHARLES OSHINUGA, GENERAL COUNSEL
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BACKGROUND

Rent Ordinance codifies right to Fair Return

- The purpose of the Rent Ordinance is to promote neighborhood and community stability, healthy housing, and affordability for renters in the City of Richmond by controlling excessive rent increases and arbitrary evictions to the greatest extent allowable under California law, while ensuring Landlords a fair and reasonable return on their investment and protecting homeowners.

Landlords are Entitled to a Fair Return

- The Rent Board’s ability to control rents is necessarily circumscribed by Constitutional principles.

- As it relates to rent control jurisdictions, these principles are satisfied so long “as the price controls are not confiscatory; i.e, they do not deprive investors of a fair return on their investment.”

- This is consistent with the stated purpose of the Rent Ordinance.

Selection of a "Fair Return" Methodology

- How do we determine what constitutes a fair return?
- There are no constitutionally established methodologies required to be used when determining what amounts to a fair return on investment.
  - Courts have rejected particular methodologies as circular and have been clear that any fair return methodology used must be "concerned with the financial integrity of the business as a whole, not the ability to obtain a return on a discrete portion of the business."
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Selection of a "Fair Return" Methodology

- The Rent Ordinance authorizes the Richmond Rent Board to create procedures/methodologies that permit an individual upward adjustment in Rent (beyond the AGA) to provide Landlords with a fair return on their investment, where the landlord has demonstrated that the individual upward adjustment is necessary to maintain a Fair Return.
- Regardless of methodology, the Rent Ordinance limits the Board's ability to grant rent increases to only those instances where the Landlord has demonstrated the rent increase is necessary to provide the Landlord a Fair Return.

Selection of a “Fair Return” Methodology

- In 2018, the Rent Board hired Kenneth Barr, the leading expert on Fair Return as applied in Rent Controlled jurisdictions. Prior to working with the Rent Board, Mr. Barr had worked with nearly all of the sister jurisdictions in California that have rent control and aided them in establishing a fair return methodology. He has also testified in numerous court proceedings where his chosen methodology was challenged and ultimately upheld. Mr. Barr’s analysis is often cited by the courts.
- Consistent with all his prior recommendations, Mr. Barr recommended that the Rent Board adopt the methodology entitled Maintenance of Net Operating Income.
- The courts have rejected other methodologies and have routinely upheld Maintenance of Net Operating Income has constitutionally valid.

Selection of a “Fair Return” Methodology

- Despite Mr. Barr’s recommendation, the Rent Board and staff engaged in months of community outreach and workshops, receiving over thousands of comments, suggestions, and several alternative methodologies.
- After considering all the community, legal, and expert input, on March 21, 2018, the Richmond Rent Board adopted a Maintenance of Net Operating Income (hereinafter, MNOI) framework —codified in Richmond Rent Board Regulation 905—as the required methodology used in determining what amounts to a fair return on investment.

MNOI OVERVIEW

MNOI Rationale

- MNOI is based on the presumption that the net operating income received by the Landlord in the Base Year provided the Landlord a Fair Return.

- Thus, so long as the net operating income (NOI) in the Base Year is maintained and adjusted for 100% of inflation, it is presumed the Landlord is receiving a Fair Return on their investment in the Base Year.

Selection of the Base Year

- MNOI presumes that the rents Landlords chose to charge, in a year free from the idea of rent control, provided Landlords a fair return on their investment, as the rents that were charged were based on general market conditions, and not the upward pressure that policy discussions of rent control may have on the market.

- In the City of Richmond, the Base Year is 2015.

The Annual General Adjustment (AGA)

- The Rent Ordinance permits a Landlord to take a rent increase equal to 100% of the inflation rate.

- This rent increase is known as the Annual General Adjustment (AGA).

- The AGA serves to maintain the Landlord's NOI and fair return on investment.

- Despite this device, there may be occasions where Landlords are still not receiving a fair return on their investment.

Net Operating Income (NOI) Calculation

- Maintaining the net operating income (NOI) in the Base Year is essential to a Landlord obtaining a fair return on their investment.

- NOI is calculated by taking the total expenses in a given year and subtracting it from the gross income received in that same year.
  - Certain expenses and income are excluded from the MNOI analysis.

Calculating the Fair Net Operating Income (NOI)

- Once one determines the net operating income (NOI) in the Base Year, that income must be compared to the net operating income in the Current Year.
  - The Current Year is the calendar year preceding the year the Landlord files the MNOI petition.
  - Prior to comparing the figures, the Base Year NOI must be adjusted by inflation (i.e the Consumer Price Index) that has occurred from the Base Year to the Current Year.

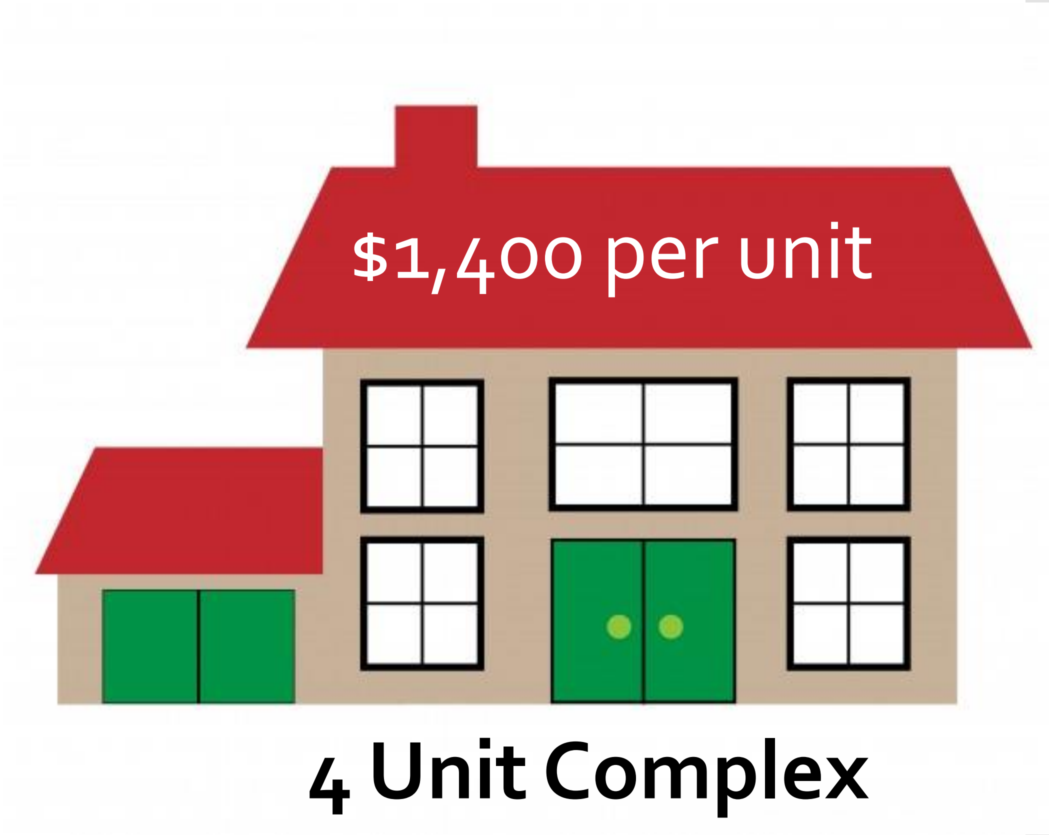
- This newly adjusted Base Year NOI is referred to as the "Fair NOI," and is compared to the Current Year NOI.

- If the NOI in the Current Year is less than the Fair net operating income, the Landlord is not receiving a fair return and is entitled to an income adjustment through the form of a rent increase.

BASIC EXAMPLE CALCULATION

Maintenance of Net Operating Income (MNOI) Calculation Example

MNOI Example Calculation



MNOI Example

MNOI calculations begin by examining the **Base Year net operating income** and **operating expenses…**

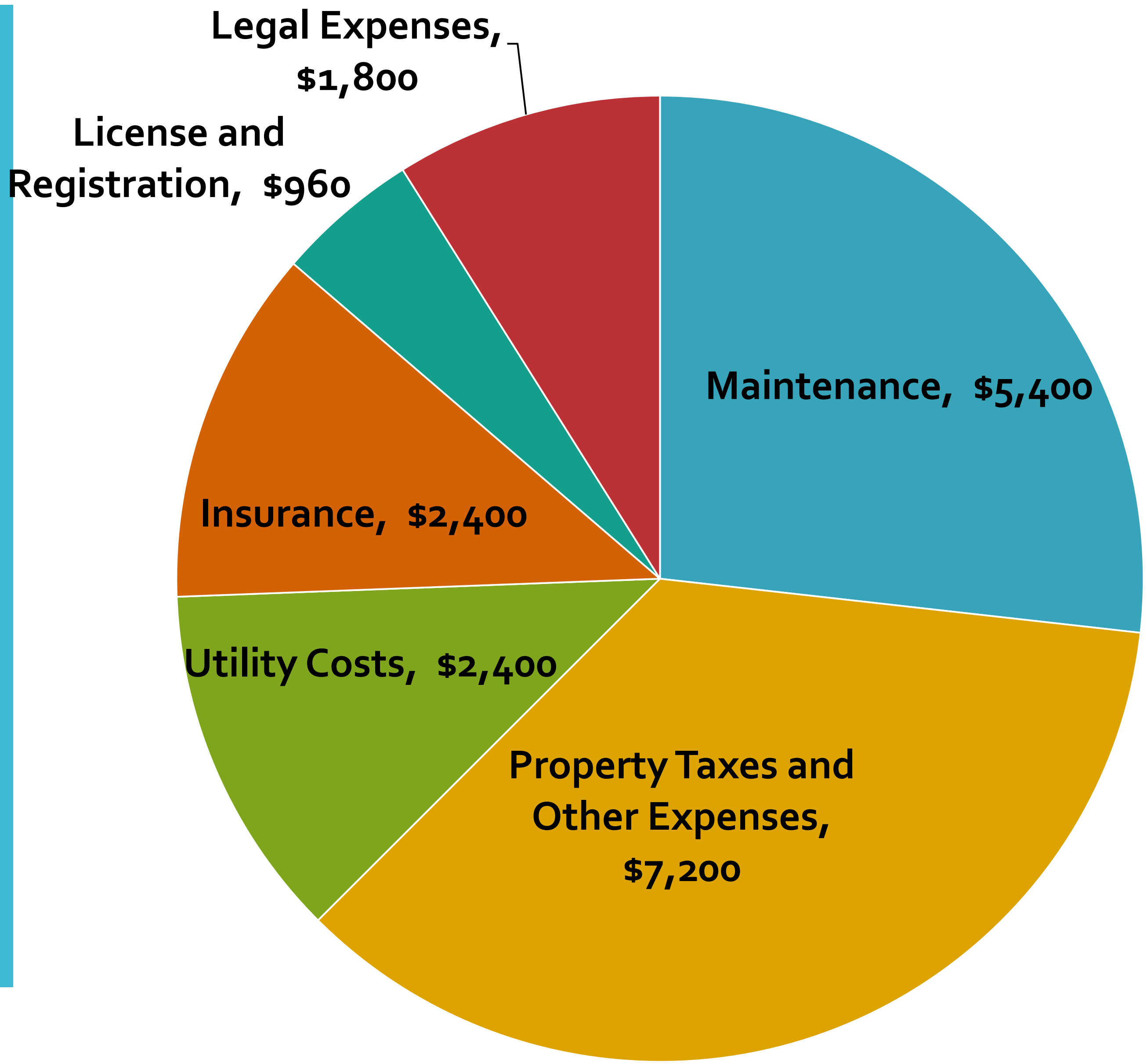
Example of Operating Expenses

Definition of "Operating Expenses"

Included in Operating Expenses	NOT Included in Operating Expenses
• Reasonable costs of operation and maintenance of the rental unit • Real property taxes • Insurance • Utility costs • Management expenses • License, registration, and other public fees • Landlord-performed labor • Legal Expenses	• Debt service costs and costs for obtaining financing • Mortgage payments or principal • Any penalties, fees, or interest assessed for violation of the ordinance or law • Land lease expenses • Political contributions • Depreciation • Any expenses for which the landlord has already been reimbursed • Unreasonable increases in expenses since the base year

Maria's Annual Operating Expenses (Hypothetical)

MNOI Example Calculation



Total Annual Operating Expenses = $20,160

What is included in operating income?

MNOI Example Calculation

Annual Net Operating Income

=

Total Annual Rent Collected

– Operating Expenses

Operating income is usually the total amount of rent collected minus expenses. For the purpose of the Maintenance of Net Operating Income (MNOI) analysis, we will be using the **annual** rental income collected.

Let's look at a 4-unit complex example with the Base Year of 2015…

MNOI Example Calculation

$67,200

Annual revenue is 4 units times $1,400 times 12 months = $67,200

$20,160

Annual expenses are 30% of revenue = $20,160

Base Year Net Operating Income =

$47,040

Annual net operating income (NOI) = $47,040

Illustration of Fair Return Using the MNOI Standard

Fast forward to 2021: Rent has increased by **$210 through AGA increases** over the span of five years. The **new Maximum Allowable Rent** for each unit is **$1,610**.

4 Unit Complex

Illustration of Fair Return Using the MNOI Standard

Maria has applied all of the Annual General Adjustment increases, but utility and management costs have also increased.

$77,280

Annual revenue for 4 units is $1,610 * 4 units * 12 months = $77,280

$26,275

Annual expenses are now 34% of revenue = $26,275

Current Year Net Operating Income =

$51,005

Annual net operating income (NOI) = $51,005

Comparing 2015 NOI to 2020 NOI

To maintain a Fair Return a Landlord's current year NOI must be equal to or greater than their Base Year NOI.

2015 NOI = $47,040

2020 NOI = $51,005

Is the Landlord maintaining a Fair Return?

What about inflation?

Illustration of Fair Return Using the MNOI Standard

The Hearing Examiner looks at the Net Operating Income in the Base Year (2015) for Maria's case.

$47,040 2015 NOI + 15% of 2015 NOI (CPI Increase) = $54,096 Fair NOI

- **Fair net operating income is the base year net operating income (NOI) adjusted by the Consumer Price Index (CPI) increase since the base year.**
  - In this hypothetical example, the CPI increased by 15%. Therefore, the fair net operating income is $47,040 increased by 15% for a total of $54,096. To receive a Fair Return, the landlord should receive an annual net operating income of $54,096.

Illustration of Fair Return Using the MNOI Standard

MNOI Example Calculation

- The Hearing Examiner has determined the Fair Net Operating Income (NOI) is $54,096 (a $3,091 difference from the Current Year NOI).
- To provide the landlord with a Net Operating Income (NOI) that generates a Fair Return, the Hearing Examiner determines each unit may receive up to a $64 increase in the Maximum Allowable Rent (a total of $256 for all 4 units).
- The Hearing Examiner checks to see how much of a percentage the rent increase will result in for each tenant. In this example, the adjustment in the Maximum Allowable Rent would result in a 4 % rent increase for each tenant.
- The Board has capped annual rent increases at 15%, which would phase in on a yearly basis the percentage change to the maximum allowable rent, in order to prevent rent shock for tenants.

ADJUSTMENT OF BASE YEAR NOI

What if Rents weren't based on General Market Conditions?

- The Base Year presumes that the rents Landlords chose to charge, in a year free from rent control, provided Landlords a fair return on their investment, as the rents that were charged were based on general market conditions.

- There are those instances where the rents that were charged or expenses incurred prior to the enactment of rent control were not based on general market conditions.

- In such case, the presumption that the rents received during the Base Year provided the Landlord a fair return may not applicable.
  - One does not look to the amount of rent charged to determine whether rents were set based on general market conditions. Rather, one looks to the basis by which rents were charged; whether the rents charged were based on general market conditions or other conditions that would constitute exceptional circumstances.

What if Rents weren't based on General Market Conditions?

- Where a Landlord believes that the Base Year did not provide a fair return, Landlords are permitted to present evidence to rebut the presumption that the Base Year net operating income provided a Fair Return.

- There are two avenues by which a Landlord may rebut the Base Year presumption:

1) The Landlord's operating expenses in the Base Year were unusually high or low in comparison to other years

2) The gross income during the Base Year was disproportionately low due to exceptional circumstances

EXCEPTIONAL CIRCUMSTANCES IN THE BASE YEAR

What if Rents weren't based on General Market Conditions?

- Landlords may rebut the Base Year presumption by demonstrating that the gross income in the Base Year was disproportionately low due to exceptional circumstances.

- This provision establishes a two-part analysis:

1) First, to rebut the Base Year presumption, a Landlord must demonstrate that an exceptional circumstance served as the basis of setting rents.
2) Second, to rebut the Base Year presumption, a Landlord must establish that because the rents were charged based on an exceptional circumstance, the gross income or rents charged in the Base Year were disproportionately low.

Factors Considered in Determination of Proportionally Low Base Rents

- In determining whether the gross income in the Base Year was disproportionately low, the Hearing Examiner must consider the following factors:

  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.

- The Hearing Examiner has discretion to afford particular weight to any given factor but must analyze each factor to determine its applicability, regardless of whether the factors were raised by the Landlord.

Base Year Rent Adjustments

- If the Landlord successfully demonstrates that: (1) the Landlord set Base Year rents based on an exceptional circumstance, and (2) the resulting rents were disproportionately low, the Landlord is entitled to an adjustment in their Base Year gross income.
  - That adjustment is reflected by artificially increasing the rents reported in the Base Year, which results in a higher Base Year NOI.

- The Hearing Examiner has the discretion to decide how such adjustment in the Base Year rents occurs, but all evidence relied upon to adjust the Base Year rents must be reasonable and substantiated by the evidence contained in the Record.

Example Calculation

- Consider a situation where Landlord's MNOI petition demonstrates a Base Year gross income of $12,000 and expenses of $6,000.
  - The resulting Base Year net operating income would be $6,000.
- Within that the same petition, it is determined that the Current Year gross income is $17,400 and expenses are $6,000.
  - The resulting Current Year net operating income would be $11,400.
- Assuming no inflation, Comparing the Current Year net operating income to the Base Year, one subtracts $6,000 from $11,400, which results in positive $5,400.
  - It would appear that the Landlord is receiving a fair return because not only has the Landlord maintained the Base Year net operating income of $6,000 in the Current Year, they have exceeded it by $5,400.

Example Calculation (continued)

- Suppose the Landlord presents evidence that they only rented to close friends and family members, and charged low rents because they wanted to give their family members a deal.

- Using the best evidence available, the Hearing Examiner would determine Base Year rent amounts that were set based on general market conditions and make an adjustment in the Landlords’ Base Year rents to reflect those rents set based on general market conditions.

Example Calculation (continued)

- Once the Hearing Examiner has made a determination as to the rents that were set based on general market conditions, the Hearing Examiner adjusts the Landlord's Base Year rents to reflect those based on general market conditions.
- Returning to our example, assume that average Base Year rents charged based on general market conditions were $1,500.
  - The Hearing Examiner would then substitute $1,500 times twelve months to determine the Base Year income. The result would be that the Base Year net operating income changes from $6,000 ($12,000 Base Year gross income minus $6,000 expenses) to $12,000 ($18,000 Base Year gross income minus $6,000 expenses).
  - Assuming no inflation, Comparing the new Base Year net operating income of $12,000 to the Current Year net operating income of $11,400, the Landlord is no longer receiving a fair return on their investment, but is $600 below maintaining their Base Year Net Operating Income.
  - As a result, the Landlord is entitled to a rent increase.

WHAT IF I DO NOT HAVE BASE YEAR INFORMATION

Projection of Base Year Operating Expenses in the Absence of Actual Data

- Regulation 905(6)(e)

- 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.)

HOW DO CAPITAL IMPROVEMENTS IMPACT MNOI

Capital Improvements and Amortization

- Regulation 905(6)(b)(viii)

- Operating expenses include the amortized costs of capital improvements 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.

- The Rent Ordinance modifies the regulation by requiring the improvement be distinguishable from ordinary repair, replacement and maintenance, and the improvement be necessary to bring the property into compliance or maintain compliance with applicable local code requirements affecting health and safety.

Anticipated Capital Improvements

- Regulation 905(8)(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

Capital Improvements and Vacancy

- Regulation 905(9)
- Any unit which received a vacancy rent increase pursuant to Civil Code section 1954.53 within one year 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.

THANK YOU

CHARLES OSHINUGA
STAFF ATTORNEY
CHARLES_OSHINUGA@CI.RICHMOND.CA.US
(510) 621-1202