



MEMORANDUM

CSFRA, Community Development Department

DATE: July 10, 2017

TO: Rental Housing Committee

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SUBJECT: Draft Regulations for Petition and Hearing Process, Fair Return Standard

RECOMMENDATION

Adopt a Resolution Establishing Regulations for the Petition Process, Hearing Process, and a Fair Return Standard for Petitions for Individual Rent Adjustments under the CSFRA.

INTRODUCTION

The purpose of the CSFRA is to promote affordability for renters in the City of Mountain View by controlling excessive rent increases, while ensuring landlords receive a fair and reasonable return on their investments. The CSFRA allows for one annual general rent increase equal to 100 percent of the Consumer Price Index (CPI). The CSFRA also provides for an individual rent adjustment petition process as a means to balance the benefits and burdens of rent stabilization. Tenants may file a Petition for a Downward Rent Adjustment for: (1) failure to maintain habitable premises; (2) a decrease in housing services or maintenance; or (3) if a landlord demands or retains rent in excess of the lawful rent pursuant to the CSFRA. A landlord may file a Petition for Upward Adjustment of Rent to ensure a fair and reasonable rate of return. Adopting a fair return standard for this petition process provides clarity, transparency, and consistency of decisions for Petitions for Upward Adjustment of Rent.

BACKGROUND

Sections 1710 and 1711 of the CSFRA charge the Rental Housing Committee (RHC) with promulgating regulations to clarify the petition process and ensure rents are set to allow for a landlord's fair return. Petitions will be heard and decided by hearing officers and may be appealed to the RHC.

In its meetings on May 22, June 8, and June 19, 2017, the RHC had the opportunity to discuss the concept of a fair return standard, hear input from the community, and also receive input solicited from stakeholders. On June 19, 2017, the RHC directed staff to draft a fair return standard regulation that maintains the net operating income received from a property in the years prior to adoption of the CSFRA by increasing the net operating income in accordance with changes to the CPI. The RHC also provided direction to staff to review the draft definitions of capital improvements and amortization schedule and provide further information regarding a potential "Vega adjustment" regulation, which would allow for further adjustments to the net operating income to which a property owner is entitled.

ANALYSIS

Together, the proposed regulations for a petition process, hearing process, and fair return standard set forth the necessary procedures and requirements for processing Petitions for Individual Rent Adjustments, and, once adopted, will allow the RHC to begin accepting and processing such petitions. Staff drafted the proposed regulations to provide clear and easy-to-follow guidance to create a basic, yet effective, process to address Petitions for Upward Adjustment of Rent and Petitions for Downward Adjustment of Rent. The RHC may change or add to these regulations at any time, depending on experiences during implementation of the petition process. The current proposal includes provisions regarding who is authorized to file a petition, the content of the petition forms, and distinct requirements for the filing of each of the petitions, the right to respond, acceptance of petitions, a prehearing settlement conference, and a summary of petition processing. These draft regulations also establish further procedures for the hearing process, including authority of hearing officers, noticing and prehearing procedures, postponement requests, conduct of the hearing, hearing record, decision contents, burden of proof, and appeals to the RHC.

Petition Process

Staff made the following edits to the Petition Process Regulations, taking into account the RHC's feedback as well as written comments:

- Sections A(2) and A(3): Single parcel is further specified as "single parcel of land or lot."
- Section B(1): Any person or organization can be a representative of the petitioner.
- Section E, F, G, and H headings are brought into conformity with language of the CSFRA.
- Sections E and F: Notice to landlord brought into conformity with language of the CSFRA.
- Section I: Clarification as to which addresses notices should be sent.
- Section K(4): Switching text to make this section easier to read.
- Section L(1): Deleted, but can be reinstated pursuant to future direction of the RHC.
- Section N: Pursuant to a letter from Juliet Brodie to the RHC, changed the prehearing settlement conference into a voluntary part of the process.

Staff has the following questions related to the Petition Process Regulations and Section C:

- *Does the RHC want to provide petition forms in Mandarin and Spanish as well as English, which would require the hiring of translators for petition forms and documents? Moreover, how does the RHC want to address hearings with individuals who are not proficient in English?*

Hearing Process

While the Hearing Process Regulations were included in the agenda packet for June 19, the item was not discussed and was continued to the July 10, 2017 meeting. Staff has made the following edits to the Hearing Process Regulations, taking into account written comments received:

- Section E(4): A section on Rules of Evidence was added to make clear that the formal rules of evidence do not apply in the administrative proceeding.
- Section F(2)(b)(iv): The last sentence relating to fixed rate of return was eliminated based on the direction provided by the RHC regarding the fair return standard.

Fair Return Standard

The fair return standard as described in these regulations is based on the most commonly used standard in California: the Maintenance of Net Operating Income (MNOI) as adjusted by the CPI. The basic steps to calculate a landlord's fair return for a rental property under the MNOI – CPI Adjustment method are outlined below.

1	Take the landlord's gross income and total qualified operating expenses for the property from the base year to calculate the base year net operating income (NOI).
2	Take the current (petition) year's gross income and total qualified operating expenses for the property to calculate the petition year NOI.
3	Identify the percentage change in the CPI between the base year and the petition year.
4	Increase the base year NOI by the percentage change in the CPI. (The landlord's NOI should increase by the percentage change in the CPI to maintain the annual value of the base year NOI.)
5	Compare the petition year NOI with the adjusted base year NOI that accounts for the CPI change.
6	If the petition year NOI is less than the base year NOI adjusted by the CPI increase, then the landlord is entitled to an upward adjustment of rents for that property so that the petition year NOI equals the base year NOI adjusted by the CPI increase.

By comparing both the gross income and operating expenses for one property for a base year and petition year, the MNOI–CPI Adjustment method of allowing landlords to earn a fair return maintains the value of the landlord’s net operating income. This methodology acknowledges increases in operating expenses (like maintenance costs and utilities) while regulating rent increases. The draft Fair Return Regulations follow this basic formula.

During its June 19 meeting, the RHC requested alternatives related to specific components of the draft Fair Return Regulations. Each option, as well as an explanation of some notable provisions of the draft Fair Return Regulations that accommodate the text of the CSFRA, are discussed below based on the order in which they appear in the draft Fair Return Regulations.

An example of how to perform the necessary calculations consistent with the proposed Net Operating Income standard is included as Attachment 5. As shown in the example, a landlord would provide evidence of their gross income generated by a particular property during the base year. The base year gross income would be reduced by operating expenses; however, only permitted operating expenses may be deducted. Moreover, any operating expenses that are capital improvements must be amortized over the life of such improvement. Following the deduction of operating expenses from gross income, the Net Operating Income for the base year is then adjusted upward by the same percentage as the increase in the CPI to arrive at the Net Operating Income for the petition year. The landlord would provide evidence of their gross income in the petition year, and operating expense would be deducted (subject to the same limitations as discussed above with regard to the base year operating expenses). In the example, the adjusted Base Year NOI is greater than the actual NOI in the petition year, so the landlord is awarded a rent increase, allocated among all of the rental units at the subject property.

1. Index for the Fair Return Standard (Sections B and C(4))

The RHC requested options regarding the index to be used for the Fair Return Regulations. The draft Fair Return Regulations reflect the staff recommendation that the RHC use the CPI–All Items for All Urban Consumers (CPI–All Items) for the San Francisco-Oakland-San Jose metropolitan area. However, the RHC could select another index, such as the CPI–Housing, which is one component of the CPI–All Items. Because CPI–Housing reflects changes in the cost of fewer goods and services than CPI–All Items, the CPI–Housing is a less-stable index. Attachment 6 provides a comparison of the CPI–All Items and CPI–Housing indices over the past seven years. As can be seen in this attachment, CPI–

Housing changes at a faster rate from CPI–All Items, and the use of CPI–Housing would be subject to more fluctuations than under the use of CPI–All Items. This variation between the indices used for purposes of fair return petitions and annual general adjustments would not further the purposes of the CSFRA because it would lead to less stable rents and potentially increase the number of fair return petitions.

Staff is unaware of any jurisdiction that uses an MNOI–CPI Adjustment fair return standard but does not use the CPI–All Items index. Berkeley, East Palo Alto, Los Angeles, Santa Monica, and West Hollywood each use the CPI–All Items index for purposes of calculating fair return. To comport with other jurisdictions that use MNOI, and to better implement the CSFRA, staff recommends that the RHC adopt the CPI–All Items index to align the annual general adjustment and fair return components of the CSFRA.

Question: Does the RHC desire to accept the staff recommendation and use the CPI – All Items for purposes of the Fair Return standard?

2. Percentage of Index for the Fair Return Standard (Section B)

The RHC requested options regarding the percentage of the change to the preferred index to be used for the Fair Return Regulations. The draft Regulations reflect the staff recommendation that the RHC allow for 100 percent of the CPI–All Items index be used to adjust a landlord’s Net Operating Income from the base year to the petition year. Notably, some jurisdictions allow net operating income to increase by 100 percent of CPI–All Items (Los Angeles and East Palo Alto), while others limit the increase to a fraction of CPI–All Items (for example, Berkeley allows 65 percent of CPI–All Items, West Hollywood and Santa Monica allow 40 percent of CPI–All Items). Staff is unaware of any jurisdiction that allows net operating income to increase by more than 100 percent of the chosen index. Moreover, Section 1707(a)(1) of the CSFRA limits the annual general adjustment to 100 percent of the change in CPI. Allowing for greater increases through the petition process may limit the impact of Section 1707(a) of the CSFRA and encourage landlords to file more petitions to avoid the limits of Section 1707 of the CSFRA.

Question: Does the RHC desire to accept the staff recommendation and use 100 percent of the chosen index?

3. Base Year (Section C(1))

The RHC requested options regarding the base year to be used for the Fair Return Regulations. Generally, the base year should reflect market conditions before implementation of a new rent stabilization law. Staff recommends that the RHC select either 2014 or 2015 as the base year, because both years are recent (so landlords likely possess or could retrieve documents related to gross income and operating expenses for those years). The theory is that each landlord obtained a net operating income for each property in 2014 or 2015 that was unaffected by the CSFRA. Because such rents were unaffected by the CSFRA and set at a level chosen by individual landlords, it is assumed that the net operating income collected during the base year provided a fair return to the landlord. Accordingly, the draft Fair Return Regulations would maintain the value of each landlord's net operating income as received in the base year. The selection of 2014 as the base year would likely result in lower gross income from lower rental rates, but would also reflect greater change in the CPI between the base and petition years. Selection of 2015 as the base year would reflect a smaller change in CPI but potentially greater rental incomes.

Question: What year does the RHC desire to use as the base year for purposes of maintaining a landlord's net operating income?

4. Management Expenses (Section E(1)(g))

Management expenses are a typical component of operating expenses, whether a property is landlord-managed or managed by a third party. However, it can be difficult to ascertain the value of a landlord's self-management services. Accordingly, many jurisdictions define reasonable management expenses as a fraction or percentage of the gross income received from a property. For instance, Berkeley and Santa Monica presume management expenses equal to 5 percent of a property's annual gross income are reasonable, while West Hollywood presumes 6 percent is reasonable. Landlords may still demonstrate that a management expense for a property costs more than 5 percent or 6 percent of the gross income received from a property, but the presumption is often helpful for self-managed properties. Staff recommends that the RHC adopt a rebuttable presumption that 6 percent of the gross income received from a property is a reasonable operating expense.

5. Reasonable Capital Reserve Account as Component of Operating Expenses (Section E(1)(i))

The CSFRA prohibits the inclusion of debt service (principal, interest, and fees) for certain debt incurred after October 19, 2015. Likewise, members of the public have expressed concern that rent stabilization may provide a disincentive for landlords to maintain or improve regulated, residential rental properties. To address these two issues, staff recommends that landlords be allowed to include a reasonable capital reserve account as one component of the operating expenses for a property, so long as the funds function as reserve accounts (e.g., the reserve accounts are segregated from other funds and remain relatively liquid so that they may be used to pay for anticipated or unexpected expenses). Staff is unaware of any other jurisdiction that allows for a property reserve account as an element of qualifying operating expenses but believes it addresses public concerns and promotes a prudent business practice among landlords.

6. Certain Debt Service Excluded from Operating Expenses (Section E(2)(e))

Section 1710 of the CSFRA prohibits the inclusion of debt service (principal, interest, and fees) for certain debt incurred after October 19, 2015. The draft Regulations follow the prohibition in the CSFRA. Notably, other jurisdictions exclude all debt service in the fair return context. Excluding all debt service would be an easier rule to implement and may reduce impacts to tenants related to the creditworthiness of their landlord (e.g., less creditworthy landlords may have higher operating costs based on access to capital and interest rates).

Question: Does the RHC desire to include debt service as one factor when reviewing fair return petitions to the extent authorized by the CSFRA?

7. Anomalous Operating Expenses (Section E(3))

Fair return calculations based on the maintenance of net operating income require analysis of operating expenses to ensure that they reasonably reflect an average year. In recognition that annual operating expenses may vary greatly from one year to the next, the draft Regulations provide Hearing Officers with the authority to adjust operating expenses in the petition year if the expenses are unreasonably low or high. Unfortunately, there is no easily referenced standard for operating expenses, and so Hearing Officers often rely on the best information available such as information about prevailing costs provided by landlords and tenants during the petition and hearing process.

8. Capital Improvements and Amortization Schedule (Sections F(1)(a) and (E(1)(h))

The CSFRA greatly constrains how the costs of capital improvements are addressed. Consistent with the CSFRA, the draft Regulations include consideration of a landlord's cost of making additions and modifications to a property that are necessary to maintain compliance with specified building standards in connection with a Petition for Upward Adjustment of Rent.

The draft Regulations propose to allow the cost of complying with the building codes contained in Mountain View City Code Section 25.58 to be included as an operating cost when calculating net operating income. This code section identifies physical standards necessary to preserve the basic health and safety of housing units in the City, and it is included as Attachment 7. Likewise, the City building standards incorporate the International Property Maintenance Code, which is also included as Attachment 8. In addition, the Regulations propose to include improvements to properties made to comply with the California Green Building Standards as codified in Chapter 4 (Residential Mandatory Measures) of Part 11 of Title 24 of the California Code of Regulations in operating costs, which is included as Attachment 9. Property repairs or improvements identified in any of the aforementioned codes would be presumed to qualify as operating expenses in compliance with the CSFRA, which requires that capital improvements be necessary to comply with health and safety codes. The City is considering the adoption of its own green building standards, and staff recommends that the RHC consider allowing improvements made pursuant to this code section as a capital improvement be included in operating expenses once the standards are enacted.

Moreover, staff recommends that the cost of qualifying capital improvements be included as one component of the operating expenses for the property that was improved. However, to avoid large rent increases that would result if the entire cost of a capital improvement were included in one year and to acknowledge that the useful life of a capital improvement is longer than one year, staff recommends that the RHC adopt an amortization schedule for categories and specific types of capital improvements. By dividing the costs of qualifying capital improvements over multiple years, landlords would be able to pass through the costs of improvements over the useful life of the improvement without defeating the purpose of the CSFRA, which is to stabilize rents.

9. Amortization of Capital Improvements (Section F(3))

As discussed above with respect to Section E(1)(h), it is appropriate to amortize the cost of permissible capital improvements over the life of such improvements to

permit a landlord to recover such costs without unfairly burdening tenants by rapidly increasing rents. The draft Regulations include a proposed amortization schedule as an attachment, to allow the RHC to easily amend the schedule without needing to modify the Regulations themselves (see Attachment 10). Moreover, the amortization schedule will provide clear guidance to landlords, tenants, and hearing officers with regard to what type of investments are eligible capital improvements for consideration in connection with a petition for Upward Adjustment of Rent and how quickly such costs may be recovered.

10. Base Year Presumption and “Vega Adjustment” (Section G)

Fair return calculations based on the maintenance of net operating income require analysis of base year net operating income, which is comprised of the base year gross income less the base year operating expenses. The purpose of the base year is to define a time frame during which a landlord’s net operating income is presumed to be fair (for instance, because the landlord had the ability to pursue an acceptable net operating income during the base year free from rent stabilization laws). The presumption that base year net operating income was fair is rebuttable; landlords can demonstrate that the base year net operating income for a property was unreasonably low because gross income was unreasonably low, and so maintaining that level of net operating income in future years would be unfair.

Adjusting base year gross income because it is unreasonably low is often referred to as a “Vega Adjustment” because of a 1990 court case. In that case, *Vega v. City of West Hollywood* (Vega), West Hollywood was required to revise the base year gross income when implementing rent stabilization based on the maintenance of net operating income.¹ West Hollywood’s ordinance allowed for base year gross income to be adjusted if income was “disproportionately low” due to “peculiar circumstances.” West Hollywood had not defined what income qualified as “disproportionately low,” which led to a complicated hearing process and, ultimately, litigation.

Although there is a legal obligation to allow a landlord to demonstrate that the base year gross income for a property was unreasonably low, staff recommends the RHC define a standard by which landlords can demonstrate gross income was unreasonably low.

After the *Vega* case, some jurisdictions defined unreasonably low gross income by referring to a standard amount of rent per unit. For instance, Berkeley defines

¹ *Vega v. City of West Hollywood* (1990) 223 Cal.App.3d 1342.

gross income from a property as unreasonably low if the base year gross income is less than 75 percent of the income that would be received for the building if the landlord charged rents defined by the U.S. Department Housing and Urban Development (HUD). HUD publishes two different rent standards based on the number of bedrooms in a unit, which are used for subsidized housing. HUD publishes fair market rents annually for each county as well as small area fair market rents for zip codes. HUD fair market rents and small area fair market rents for 2014 and 2015 are included in Attachment 11 and offer one easily understood measure of unreasonably low income.

Question: Does the RHC wish to identify a standard to define unreasonably low base year gross income? If so, should the standard relate to HUD fair market rents?

11. Base Year Records (Sections I and H)

In order to maintain net operating income, Hearing Officers and the RHC must ascertain the net operating income from the property in the base year. Section I of the draft Regulations requires landlords to maintain records that demonstrate the gross income and operating expenses for each property that contains a rent-stabilized unit. In anticipation that adequate records may not be available in all circumstances, Section H of the draft Regulations allow for the estimation of base-year operating expenses based on the best information available. Such information could include records for similar properties, whether owned by the same landlord or another party.

FISCAL IMPACT

The adopted Regulations will be used to determine the time and, consequently, the costs the Hearing Officers spend on each petition and, therefore, the budget of the RHC.

AvD-JLQ/5/CDD/RHC

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- Attachments:
1. Resolution
 2. Chapter 4 Petition Process
 3. Chapter 5 Hearing Process
 4. Chapter 6 Fair Return Standard
 5. MNOI Calculation Example
 6. CPI Indexes
 7. Mountain View City Code 25.58
 8. 2015 IPM Codes CH3-7
 9. CA Green Building Standards Code
 10. Draft Amortization Schedule
 11. HUD Fair Market Rents