MEMORANDUM

CSFRA, Community Development Department

DATE: August 28, 2017

TO: Rental Housing Committee

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SUBJECT: Draft Regulations for Vega Adjustment (Fair Return Standard—Ch. 6)

RECOMMENDATION

Adopt a Resolution Establishing Regulations for a Vega Adjustment to be Included in the Fair Return Standard of the Regulations (Chapter 6).

INTRODUCTION

The purpose of the Community Stabilization and Fair Rent Act (CSFRA) is to stabilize rents in Mountain View by making rent increases that might otherwise be imposed on resident renters more predictable, while ensuring landlords receive a fair and reasonable return on their investments. During its July 24 meeting, the Rental Housing Committee (RHC) adopted three chapters of regulations to implement Sections 1710 and 1711 of the CSFRA defining the petition and hearing process for landlord and tenant petitions for upward and downward adjustments of rent. In the motion to adopt the regulations, the RHC directed staff to draft a "generous" Vega Adjustment regulation, with at least two methodologies as described below.

BACKGROUND

The RHC has adopted a fair return standard that ensures landlords may earn a fair rate of return on their investment, as required by the U.S. and California Constitutions, using the maintenance of net operating income (MNOI) methodology. The purpose of the MNOI methodology is to "maintain" the value of the net operating income received by the landlord prior to stabilization of rents.

The first step of the MNOI methodology identifies the net operating income a landlord received in the Base Year (i.e., 2015 gross income from the property, less 2015 operating expenses). The second step adjusts the 2015 net operating income based on an index

(the CPI—Rent of Primary Residence), in order to "maintain" the value of the base year net operating income. If in the Petition Year the landlord is not earning at least the 2015 net operating income as adjusted by the CPI—Rent of Primary Residence from the property, then the landlord would be entitled to a rent increase beyond that allowed by annual general adjustments and vacancy decontrol.

The Vega Adjustment addresses situations where the base year net operating income is unusually low because the gross income from the property was unreasonably low (e.g., the rent charged for one or more Rent Stabilized Units in 2015 was unreasonably low). Notably, Vega Adjustments are one-way: they allow increases in rent to address unreasonably low Base Year Gross Income but do not allow downward adjustments for high Base Year Gross Income. In a 1990 court case, *Vega v. City of West Hollywood*, West Hollywood was required to revise the Base Year Gross Income for a landlord when implementing rent stabilization using the MNOI methodology.[1] West Hollywood's rent stabilization ordinance allowed for Base Year Gross Income to be adjusted if that income was "disproportionately low" due to "peculiar circumstances." West Hollywood had not defined what income qualified as "disproportionately low," which lead to a complicated hearing process and, ultimately, litigation. Therefore, staff recommends defining "unreasonably low" rents to determine Vega Adjustments.

The RHC identified two potential methods to define and quantify "unreasonably low" Base Year Gross Income in accordance with the Vega case to provide a clear rule for landlords, tenants, and Hearing Officers. One method to define unreasonably low Base Year Gross Income would be based on standardized rent amounts published by the U.S. Department of Housing and Urban Development ("HUD"). Another method would require statistical analysis, comparing the rent for any unit for which a landlord allegedly received unreasonably low rent in the Base Year with the average rent charged by the same landlord in the Base Year for other Rent Stabilized Units in Mountain View. Options incorporating each methodology are analyzed below.

ANALYSIS

In response to the direction from the RHC, staff has prepared three options of draft regulations to define and quantify unreasonably low Base Year Gross Income based on data published by HUD and based on a statistical analysis of the petitioner-landlord's Base Year rents. In addition to the three proposed regulation methodologies, there are two questions that will inform any proposal. First, which HUD data should be used in each of the draft regulations? After selecting the data set and methodology, there is a question about the proper allocation of any rent increases based on a Vega Adjustment.

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

HUD County-Level and Zip Code-Level Fair Market Rents

HUD annually estimates fair market rents (FMRs) for 530 metropolitan areas and 2,045 nonmetropolitan County FMR areas. Standard FMR data is published at the county level (e.g., the draft regulations could use data published for all of Santa Clara County). HUD recently began publishing more localized FMRs by zip code, including data covering Mountain View.

County-level FMRs are primarily used to determine payment standard amounts for the Housing Choice Voucher Program, to determine initial renewal rents for some expiring project-based Section 8 contracts, to determine initial rents for housing assistance payment contracts in the Moderate Rehabilitation Single-Room Occupancy Program, and to serve as a rent ceiling in the HOME rental assistance program. Zip code -level FMRs are a pilot project and are officially permitted to be used only to set Section 8 Housing Choice Voucher payment standards in the Dallas, Texas HUD Metropolitan FMR Area and by public housing authorities participating in the Small Area FMR Demonstration Program. Adequate Santa Clara County-level and zip code-level data is available for the Base Year of 2015 to use either data set. The HUD County-level and zip code-level FMRs for the 2015 Base Year are listed below.

	Efficiency	1-Bedroom	2-Bedroom	3-Bedroom	4-Bedroom
Santa Clara County	$1,213	$1,419	$1,809	$2,325	$2,636
94035	$1,210	$1,420	$1,810	$2,550	$3,120
94040	$1,210	$1,410	$1,800	$2,540	$3,100
94041	$1,270	$1,480	$1,890	$2,670	$3,250
94042	$1,210	$1,420	$1,810	$2,550	$3,120
94043	$1,250	$1,460	$1,860	$2,620	$3,200

As shown in the table above, some of the zip code-level FMRs exceed the County-level FMRs, and some zip code-level FMRs are less than the County-level FMRs. A map of zip code in Mountain View is included with this staff report as Attachment 1. In order to avoid unnecessarily complicating the Vega Adjustment methodology, to ensure that each Mountain View landlord is treated equally regardless of the location of the property, and to discourage further stratification of neighborhood rental markets in Mountain View, staff recommends the RHC adopt the County-level FMRs for use in any of the Vega Adjustment methodologies described below.

Option A: HUD Fair Market Rents—Per Unit Adjustment

Option A, the FMR—Per Unit Adjustment, is the simplest method to quantify unreasonably low unit rents in the Base Year. Upon submitting a petition for upward adjustment of rents, if a landlord received less than the identified FMR rent per month during the Base Year for a Rent Stabilized Unit in the subject property, then that

landlord's Base Year Gross Income would be increased to equal what the landlord would have hypothetically earned if the landlord had received the FMR rent for that unit. An example of the FMR—Per Unit Adjustment methodology is provided below.

EXAMPLE 1: County-Level FMR – Per Unit Adjustment

Unit	**Unit Type**	**Rent/Month**	**Annual Rent/Unit**	**Base Year Gross Income**
1	Efficiency	$1,150	$13,800	$108,000
2	Efficiency	$1,250	$15,000	
3	1-Bedroom	$1,500	$18,000	
4	1-Bedroom	$1,550	$18,600	
5	2-Bedroom	$1,750	$21,000	
6	2-Bedroom	$1,800	$21,600	
County-Level FMR—Per Unit Adjustment (Applied to Unit 1)				**Vega Adjusted Base Year Gross Income**
~~1~~	~~Efficiency~~	~~$1,150~~	~~$13,800~~	$108,756
1	Efficiency	$1,213	$14,556	

Option B: HUD Fair Market Rents—Per Property Adjustment

Option B, the FMR—Per Property Adjustment, is slightly more complicated than Option A, the FMR—Per Unit Adjustment, but better accommodates the MNOI methodology by quantifying unreasonably low Base Year unit rents in the context of the property. Upon submitting a petition for upward adjustment of rents, the landlord's Base Year Gross Income would be compared to the hypothetical Base Year Gross Income that the landlord would have received if the landlord had charged FMR rents for all units in the property. If the landlord's Base Year Gross Income were less than the hypothetical Gross Income using the FMRs, then the landlord's petition for upward adjustment of rents would use the hypothetical Gross Income for purposes of the MNOI methodology. Example 2 shows the FMR—Per Property Adjustment methodology.

EXAMPLE 2: County-Level FMR – Per Property Adjustment

Unit	Unit Type	Rent/Month	Annual Rent/Unit	Base Year Gross Income
1	Efficiency	$1,150	$13,800	
2	Efficiency	$1,250	$15,000	
3	1-Bedroom	$1,500	$18,000	***$108,000***
4	1-Bedroom	$1,550	$18,600	
5	2-Bedroom	$1,750	$21,000	
6	2-Bedroom	$1,800	$21,600	
County-Level FMR—Per Property Adjustment				**Vega Adjusted Base Year Gross Income**
Unit	**Unit Type**	**Rent/Month**	**Annual Rent/Unit**	
1	Efficiency	$1,213	$14,556	
2	Efficiency	$1,213	$14,556	
3	1-Bedroom	$1,419	$17,028	***$106,584***
4	1-Bedroom	$1,419	$17,028	
5	2-Bedroom	$1,809	$21,708	
6	2-Bedroom	$1,809	$20,708	
Base Year Gross Income > Vega Adjustment, so no Vega Adjustment warranted				

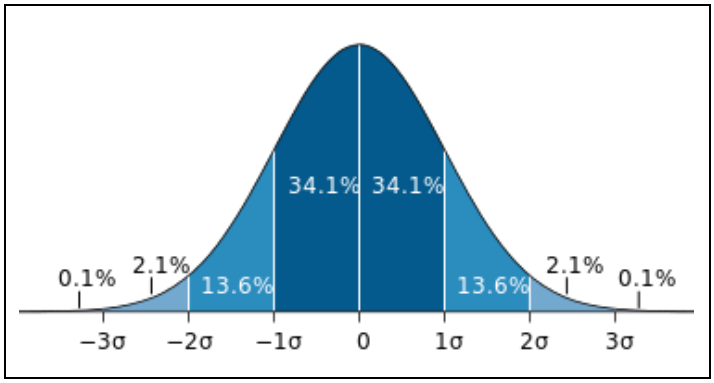
Example 2 uses the same unit count, unit mix, and rents as Example 1. However, in Example 2, Base Year Gross Income ($108,000) is greater than the Vega Adjusted Base Year Gross Income ($106,584) and so the landlord would not be entitled to a Vega Adjustment for that property. In this example, if the Base Year Gross Income were less than $106,584, then the landlord would be entitled to a Vega Adjustment.

The FMR—Per Property Adjustment better fulfills the purposes of the MNOI methodology by looking holistically at a landlord's gross income from the property. The FMR—Per Property Adjustment is more consistent with the MNOI fair return methodology than the FMR—Per Unit Adjustment, which adjusts only for individual units with unreasonably low rents without accounting for other unit rents from the property that may cross-subsidize or otherwise justify the unreasonably low rent from a particular unit.

Option C: Two Standard Deviations from Mean Rents Received by Landlord

Option C, initially outlined by RHC member Means, would quantify unreasonably low rent on a per-unit basis in the Base Year. Upon submitting a petition for upward adjustment of rents, a Hearing Officer would compare the difference between the monthly rent for each unit with the average rent charged by the landlord for all units in the same property. If the monthly rent for any unit was less than the average monthly rent charged for all units in the building by the landlord by two standard deviations, then the landlord would be entitled to a Vega Adjustment for the property.

FIGURE 1: Normal Distribution[2]



A standard deviation is a statistical quantification of variations among a set of numbers. Figure 1 visualizes what is referred to as a "normal distribution." The percentages in and above the figure show where most of the data points would be graphed (e.g., most data points are clustered near the center line or mean). The numbers and symbol (σ or sigma) below the figure identifies the standard deviation associated with each statistical area in a normal distribution (e.g., a standard deviation measures the statistical distance between one data point and the average value of the complete data set). Zero sigma (0) is the center line, or the statistical mean. Thirty-four and one-tenth percent (34.1%) of the data points in a normal distribution will be between the mean and positive one sigma (1σ); 64.2 percent of all data points in a normal distribution will be plus or minus one standard deviation from the mean (+/- 1σ, the dark blue area in Figure 1). Similarly, 95.6 percent of all data points will be plus or minus two standard deviations from the mean (+/- 2σ).

For use in the Vega Adjustment setting, the average, mean rent would be zero on the normal distribution figure. Any unit with an average monthly rent in the Base Year that was less than negative two sigma (-2σ) would be considered unreasonably low and therefore qualify for a Vega Adjustment.

Example 3 below demonstrates how the standard deviation methodology would work using the same rents as Examples 1 and 2. Like Example 2, the two standard deviation methodology does not result in a Vega Adjustment in Example 3.

[2] Image retrieved from Wikipedia: https://en.wikipedia.org/wiki/Standard_deviation

EXAMPLE 3: Two Standard Deviations from Mean Rents Adjustment

Unit	**Unit Type**	**Rent/Month** ($)	**Annual Rent/Unit** ($)	**Difference** Unit Rent less Mean Rent ($)	**Qualifies for Vega Adjustment?**
1	Efficiency	1,150	13,800	- 350	No
2	Efficiency	1,250	15,000	- 250	
3	1-Bedroom	1,500	18,000	0	
4	1-Bedroom	1,550	18,600	50	
5	2-Bedroom	1,750	21,000	250	
6	2-Bedroom	1,800	21,600	300	
		Sum	108,000		
		Mean Monthly Rent *(Sum/Unit Count)/12 Months*	1,500		
		Standard Deviation	238.05		
		Two Standard Deviations	476.10		

Mathematically the two standard deviation methodology would never allow a Vega Adjustment for properties with five or fewer units because any rents charged for the five units will always fall within two standard deviations of the mean rent, even if one of the five units paid only one dollar per month. Accordingly, staff recommends that the two standard deviation methodology use the HUD FMRs to augment the rents of four- and five-unit properties.

Example 4 below demonstrates how the HUD FMRs would be used to augment rents for a four-unit property, as drafted in Option C of the regulations.

EXAMPLE 4: Two Standard Deviations from Mean Rents Adjustment with HUD FMRs

Unit	**Unit Type**	**Rent/ Month** ($)	**Annual Rent/Unit** ($)	**Difference** Unit Rent less Mean Rent ($)	**Qualifies for Vega Adjustment?**
1	1-Bedroom	900	10,800	- 523	Yes
2	1-Bedroom	1,600	19,200	177	
3	1-Bedroom	1,600	19,200	177	
4	1-Bedroom	1,600	19,200	177	
FMR	1-Bedroom	1,419	17,028		
FMR	1-Bedroom	1,419	17,028		
		Sum	102,456		
		Mean Monthly Rent *(Sum/Unit Count)/12 Months*	1,423		
		Standard Deviation	247.50		
		Two Standard Deviations	495		

Because of the complexity of the standard deviation methodology and as it requires augmentation for four and five unit properties, staff recommends using another methodology.

Allocation of Rent Increases Based on the Vega Adjustment

It is important to note that the Vega Adjustment standard is one component of the Fair Return Standard and any upward increase in rent in excess of the annual general adjustment under the CSFRA requires a landlord petition. However, properties with units for which unreasonably low rents were charged in 2015, and that have not experienced vacancy decontrol, will be more likely to receive a rent increase under the MNOI fair return methodology.

The RHC must determine whether the portion of the rent increase attributed to the Vega Adjustment should be allocated only to those units that triggered the Vega Adjustment, or should be equally allocated to all units in the building. Either of these variants (allocating Vega Adjustment-based rent increases per unit or equally to all units) can be accommodated in any of the options (FMR—Per Unit Adjustment, FMR—Per Property Adjustment, or Two Standard Deviations from Mean Rents).

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.

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896-08-28-17M-E

Attachments:
1. Map of Zip Codes in Mountain View
2. Standard Deviation Formula and Explanation
3. Draft Vega Adjustment Regulation to be Inserted in Chapter 6 Fair Return Standard