CITY OF MOUNTAIN VIEW

MEMORANDUM

CSFRA, Community Development Department

DATE: May 22, 2017

TO: Rental Housing Committee (RHC)

FROM: Jannie Quinn, City Attorney
Anky van Deursen, Associate Planner
Karen Tiedemann, Special Counsel
Justin Bigelow, Special Counsel

SUBJECT: RHC Consideration of a Fair Return Standard

INTRODUCTION

One purpose of the Community Stabilization and Fair Rent Act (CSFRA) is to control excessive rent increases that might otherwise be imposed on resident renters, while ensuring landlords may receive a fair and reasonable return on their investment. The dual nature of this CSFRA purpose is a common function of government regulatory authority: the CSFRA must not unduly burden one group (landlords) in order to benefit another group (renters).

Rent stabilization laws throughout California balance the benefits and burdens of rent stabilization by adopting various fair return standards. This staff report discusses fair return standards, briefly reviewing the fair return concept as well as the legal necessity to select a standard, analyzing three standard methodologies for calculating a fair return, and ultimately recommending that the Rental Housing Committee (RHC) select a fair return standard methodology for which staff may draft regulations for future discussion and adoption by the RHC.

BACKGROUND

The U.S. and California Constitutions prohibit governments from taking private property without just compensation.[1] Legal challenges to rent control have argued that limits on rent increases take value from a landlord's property without just compensation; courts have disagreed so long as the rent control ordinance allows a

[1] U.S. Const. Amend. V; Cal. Const. Art. I, § 19.

landlord to earn a reasonable or fair return.[2] The California Supreme Court has clarified that various formulas and methodologies may be used to reach the desired result (allowing a fair return), and for constitutional purposes, "it is the result reached not the method employed which is controlling."[3]

In addition to meeting the constitutional requirements for price controls, adoption of a fair return standard provides benefits to landlords, the general public, and the RHC. Adopting a fair return standard provides clarity and transparency to the public, including landlords whose properties are regulated by the CSFRA. Landlords will benefit from understanding what constitutes a fair return, especially if the RHC adopts a clear formula upon which landlords and the business community can rely for future transactions.

Moreover, adopting one formula to calculate each landlord's fair return provides consistency among all landlords regulated by the CSFRA, as well as clear guidance to hearing officers and to the RHC when addressing petitions by landlords for rent increases. For instance, without a standardized methodology to calculate a fair return, each hearing officer could treat every landlord's petition for rent increase differently. Adopting a fair return standard facilitates equal treatment of each landlord and their tenants. Rent stabilization policies without a standardized fair return methodology could be subject to additional legal challenge for treating similarly situated landlords differently and arbitrarily.

Section 1710(a) of the CSFRA specifically charges the 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. While subsections (2) and (3) of Section 1710(a) identify factors that should be either considered or excluded from consideration when calculating a fair return, the CSFRA does not identify or create a fair return methodology to apply uniformly to all petitions. Within the constraints of subsections (2) and (3), the RHC may adopt any of the fair return standards identified below, a new variant of the described standards, or none at all.

FAIR RETURN STANDARDS

This section describes three potential fair return standards that may be adopted by the RHC and concludes with an explanation of the staff recommendation.

---

[2] *See Block v. Hirsh* (1921) 256 U.S. 135; *Fisher v. City of Berkeley* (1984) 37 Cal. 3d 644.
[3] *Carson Mobilehome Park Owners' Ass'n v. City of Carson* (1983) 35 Cal. 3d 184, 191.

1. Maintenance of Net Operating Income—CPI Adjustment

The most commonly used fair return standard in California focuses on the maintenance of net operating income (MNOI). To calculate a landlord's fair return for a rental property, a hearing officer would look to the landlord's gross income from the property and total qualified operating expenses for the property from a base year (2015) to identify the net operating income (NOI) for the base year. After identifying the dollar amount of the base year NOI, that amount is increased by an inflationary index which increases with changes in the consumer price index (CPI) between the base year and the petition year, or some portion of the CPI. A simplified example calculation is provided in Table 1 below.

The MNOI—CPI Adjustment calculation in Table 1 shows that the CPI between 2015 (the base year) and 2020 (the petition year) has increased by 40 points. Accordingly, the landlord's NOI should increase by 40 percent from $60,000 to $84,000. A hearing officer would review the gross income from and qualified expenses for the property in the petition year and authorize a rent adjustment (if necessary) to allow the landlord to earn an NOI of $84,000.

Table 1: MNOI—CPI Adjustment Sample Calculation

Year	CPI	Property Income	Property Operating Expenses	Net Operating Income
2015	100	$100,000	$40,000	$60,000
2020	140			$84,000

While the NOI calculation is simple, MNOI—CPI Adjustment methodology requires confirmation of operating expenses for the base and current years, which presents challenges. First, as previously noted, subsections (2) and (3) of Section 1710(a) of the CSFRA includes and excludes certain factors for purposes of calculating a landlord's fair return. Second, landlords may have incomplete records to demonstrate operating expenses. Finally, operating expenses do not always increase or decrease in accordance with inflation indexes—landlords may have years with one-time spikes in expenses that can impact the determination of a petition for rent increase. The RHC could avoid this potential evasion of the purposes of the CSFRA with regulations that give hearing officers and the RHC guidance on how to deal with anomalous situations to ensure that all petitions are considered using the same standards.

2. Maintenance of Net Operating Income—Ratio Adjustment

Another variant of the MNOI fair return standard allows rent increases in proportion to increases in qualified operating expenses. Again, the MNOI—Ratio Adjustment compares NOI between a base year and the petition year. However, the base year can be any year, including the 12 months prior to the petition year. After the base year is defined in an ordinance or regulation, a hearing officer calculates the NOI for a property for the base year. However, the NOI is the numerator of the NOI Ratio and the operating expenses are the denominator (e.g., $^{\text{NOI}}/_{\text{property operating expenses}}$). The hearing officer would then confirm the operating expenses for the petition year. Finally the hearing officer would compare the base year NOI Ratio to the petition year property expenses to calculate the petition year NOI, and ultimately any increase in rent. A simplified example calculation using the MNOI—Ratio Adjustment is provided in Table 2 below.

Table 2: MNOI—Ratio Adjustment Sample Calculation

Year	Property Income	Property Operating Expenses	Net Operating Income	NOI Ratio
2016	$100,000	$40,000	$60,000	$^{\$60k}/_{\$40k} = 1.5$
2020		$60,000	X = $90,000	$^{\$60k}/_{X} = 1.5$

The MNOI—Proportional Adjustment calculation in Table 2 shows that the landlord's operating expenses increased from $40,000 to $60,000 between 2016 (the example base year) and 2020 (the petition year), which is a 50 percent increase in qualified operating expenses. To maintain the landlord's NOI Ratio of 1.5, the landlord's NOI should equal $90,000. A hearing officer would review the actual property income for the petition year and authorize a rent adjustment (if necessary) to allow the landlord to earn a gross income of $150,000, which would equal an NOI of $90,000 when property operating expenses are subtracted.

Note, if the qualified operating expenses had increased by 40 percent between the base and petition years, Table 2 would provide the same fair return to the landlord as the MNOI—CPI Adjustment example in Table 1. The two MNOI fair return methodologies emphasize different factors. Table 3 offers a comparison of the two MNOI methodologies based on a CPI increase of 40 percent and a 50 percent increase in qualified operating expenses. Table 3 assumes rents (property income) also increased with the CPI from the base to petition years.

Table 3: MNOI—CPI and Ratio Adjustments Comparison

	Year	CPI	Property Income	Property Operating Expenses	Net Operating Income	NOI Ratio	Authorized Property Income Increase
CPI	2015	100	$100,000	$40,000	$60,000	N/A	($84k+$60k = $144k) ($144k–$140k = $4k) **$4,000**
	2020	140	$140,000	$60,000	$84,000	N/A	
Ratio	2015	100	$100,000	$40,000	$60,000	1.5	($90k+$60k = $150k) ($150k–$140k = $10k) **$10,000**
	2020	140	$140,000	$60,000	$90,000	1.5	

As indicated in Table 3, both MNOI calculations require careful scrutiny of property operating expenses in the base and petition years. In Table 3, the hearing officer would allocate either a $4,000 or $10,000 increase among the tenants in the property based on the 40 percent increase in CPI and 50 percent increase in qualified operating expenses, respectively. In this example, the Ratio Adjustment methodology allows a greater increase in rents due to the increased operating expenses. If qualified operating expenses either did not increase or decreased, then the landlord would not be entitled to an increase beyond the Annual General Adjustment authorized by Section 1707 of the CSFRA.

Generally, the CPI Adjustment methodology will offer the same stability as the CPI, while the Ratio Adjustment methodology will respond to fluctuations in operating expenses.

3. <u>Fixed Return on Investment</u>

The Fixed Return on Investment methodology is a variation on the fair return standard that was developed to regulate utilities and later adopted by some jurisdictions that regulate rents in mobile home parks. First, a deliberative body will identify a standard rate of return (percentage) that applies to each landlord's investment, generally between 4 percent and 12 percent. The standard or fair rate of return is used to calculate a landlord's minimum NOI. To determine whether a landlord is earning a fair return, a hearing officer would first identify the landlord's investment (e.g., the value of the property and improvements). Second, the hearing officer would multiply the investment by the adopted rate of return. Third, the hearing officer would compare the sum of the investment multiplied by the rate of return with the net operating income before debt service. If the investment multiplied by the rate of return is less than the net operating income, then the landlord would be entitled to increase rents on the property.

Notably, the Fixed Return on Investment calculation can also be performed based on a landlord's actual or cash investment in a property. However, the appropriate comparison figure for a Return on Investment standard using the actual cash investment is project cash flow (e.g., NOI less the costs of debt service). Subsection (3)(A) of Section 1710(a) of the CSFRA expressly excludes certain debt service costs from the fair return calculation.[4] Accordingly, the examples in Table 4 use the property value (including improvements) as the "investment" in order to calculate the minimum NOI. Table 4 provides two simplified examples of return on investment calculations using 5 percent and 9 percent rates of return. Both examples assume a $1 Million property value (investment), $120,000 in gross income, and $60,000 in qualified expenses before debt service.

Table 4: Fixed Return on Investment Sample Calculation

Rate of Return	Investment	Min. Annual NOI	Property Income	Property Operating Expenses	Net Operating Income	Authorized Property Income Increase
5%	$1,000,000	$50,000	$120,000	$60,000	$60,000	($50k-$60k = -$10k) **No Increase**
9%	$1,000,000	$90,000	$120,000	$60,000	$60,000	($90k-$60k = $30k) **$30,000**

As shown in Table 4, the different rates of return on investment lead to large disparities in the rents that may be charged. In addition to requiring careful scrutiny of operating expenses (as noted regarding MNOI calculations), the return on investment methodology demands critical examination of the investment valuation. For example, the valuation of the investment (property and improvements) could be defined as fair market value (with or without depreciation), which could require an appraisal and other documentation that would increase the administrative cost for a petition and subject rent increases to market swings. Another variation could value the investment equal to the tax assessor's valuation, which could subject tenants to large rent increases when a property changes ownership.

---

[4] The exclusion of debt service (e.g., principal, interest, and financing fees) from qualified operating expenses is common in California rent stabilization policies. Exclusion of debt service is appropriate and supported by recent judicial decisions. First, debt service terms are unique to the landlord and it would be arbitrary and unfair to privilege tenants of a landlord with better credit as compared to landlords with worse credit and so more expensive debt service costs. Second, including debt service as a qualified operating expense could provide the perverse incentive of encouraging individuals to acquire or refinance properties with less favorable financing terms under the false assumption that they would be entitled to a fair return. Rent stabilization policies cannot preclude a landlord from earning a fair return, but do not guarantee that a fair return will be received.

DISCUSSION

All three standards would provide clarity and transparency to the general public, as well as certainty for landlords. Likewise, the three methodologies have withstood prior legal challenge. Still, there are different benefits and burdens related to each of the three fair return methodologies described above that implicate policy decisions for the RHC to consider.

First, the easiest methodology to administer is likely the MNOI—CPI Adjustment calculation because it requires the least amount of information from landlords and tenants. However, this methodology requires detailed information for the base year, which may be increasingly difficult to acquire over time. In contrast, the MNOI—Ratio Adjustment calculation requires at least two years of operating expense information, though the two years could be the two most-recently completed years if chosen by the RHC. The most complex calculation is likely to be the Return on Investment methodology, because it requires analysis both of operating expenses and investment valuation.

Second, the MNOI and Return on Investment methodologies treat landlord's investments differently. The MNOI variants maintain each landlord's original investment expectation by maintaining their NOI at a level equal in some form to the NOI the landlord bargained for during the base year. Notably, MNOI—CPI Adjustment attempts to honor each landlord's initial business agreement by providing for an NOI equal to an amount the landlord bargained for prior to regulation of rents, adjusted by the CPI. In contrast, the Return on Investment calculation applies a uniform rate of return on investment to all landlords, regardless of any individual landlord's prior business arrangement. Accordingly, each methodology treats landlords equally but in different ways and with varying results.

For reference purposes, Table 5 provides a summary of the fair return standards adopted by other California jurisdictions. In addition, a memo further describing the various fair return standards is attached to this memo.

Table 5: Fair Return Standards in California

Jurisdiction	Fair Return Standard
Berkeley	MNOI (CPI), adopted by regulation
Santa Monica	MNOI (CPI), adopted by regulation
Los Angeles	MNOI (CPI), adopted by regulation
East Palo Alto	MNOI (CPI), in ordinance
West Hollywood	MNOI (CPI), in ordinance
Beverly Hills	MNOI (CPI), in ordinance
Alameda	List of factors, no specific standard
Oakland	Hybrid MNOI (CPI, plus pass through of some cost increases over prior year)
San Jose	MNOI (CPI), proposed and under revision
San Francisco	MNOI (Ratio), adopted by regulation
Richmond	List of factors, no specific standard
Los Gatos	Increases in operating costs and debt service, no specific standard
Hayward	List of factors, no specific standard, limited pass through increases in debt service

RECOMMENDATION

Staff recommends the RHC pursue adoption of the MNOI—CPI Adjustment fair return standard because it is widely used in California, offers the simplest calculations for hearing officers and the RHC, and maintains individual landlords' net operating income as received prior to regulation of rents. Table 6 provides a chart comparing the three standard methodologies in support of the staff recommendation.

Table 6: Summary Analysis of Fair Return Standards

Metric	MNOI-CPI Adjustment	MNOI—Ratio Adjustment	Fixed Return on Investment
Ease of Administration	+	/	-
Fairness to Landlords & Tenants	/	/	/
Use in California	+	/	-
Note: "+" means positive attribute for given metric; "/" means neutral; "-" means negative.			

QUESTIONS FOR RHC CONSIDERATION

Q1: Does the RHC wish to adopt a regulation setting forth the method and a specific standard to be used to calculate fair return in a petition process for upward adjustment of rent?

Q2: If the RHC wishes to adopt a fair return standard, which standard should be incorporated into a draft regulation for the RHC to review and consider?

Q2(a) If the RHC wishes to adopt either an MNOI variant or Fixed Return on Investment methodology as the fair return standard:

- How would the RHC prefer to identify qualifying operating expenses as compared to capital improvement costs that are precluded from consideration under CSFRA § 1710(a)(3)(C)? Should regulations include a list of common improvements that are either included or excluded from operating expenses?

- How would the RHC prefer to address anomalies (spikes) in annual operating costs? Should regulations include a standard amortization schedule for common improvements that provide benefits to tenants for more than one year even though purchased in one year?

Q2(b) If the RHC wishes to pursue the MNOI—CPI Adjustment methodology to determine landlords' fair return petitions, then would the RHC prefer to allow NOI to increase with all or a portion of any increase in the CPI?

Q2(c) If the RHC wishes to pursue the MNOI—Ratio Adjustment methodology to determine landlords' fair return petitions, then would the RHC prefer to define one base year for all petitions or allow hearing officers to define the appropriate base year on a petition-by-petition basis?

Q2(d) If the RHC wishes to pursue the Fixed Return on Investment methodology to determine landlords' fair return petitions:

- Would the RHC prefer to define the fixed rate of return in the regulations in perpetuity, on annual basis, or at some other interval?
- What information or factors would inform the RHC's determination of a fixed rate of return (i.e., common rates or indices)?

Q3 How does the RHC wish to solicit public input for the fair return standard regulation?

FISCAL IMPACT

The methodology selected could impact the time and costs the hearing officers spend on each petition, and therefore, the budget of the RHC. Staff's recommendation would result in the most effective methodology to implement.

NEXT STEPS

Based on the RHC's direction, staff will draft a fair return regulation and return to the RHC at an upcoming meeting.

JLQ-AvD-KT-JB/AK/3/CDD
896-05-22-17M-E

Attachments: 1. Section 1710 CSFRA
2. Fair Return Memo by Ken Baar