



## CITY OF MOUNTAIN VIEW

### MEMORANDUM

CSFRA, Community Development Department

**DATE:** June 19, 2017

**TO:** Rental Housing Committee

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

**SUBJECT:** Fair Return Standard

---

#### **RECOMMENDATION**

Staff recommends the Rental Housing Committee consider the public input provided and select a fair return standard and direct staff to draft regulations for future adoption.

#### **BACKGROUND**

In its meeting on May 22, 2017, the Rental Housing Committee (RHC) was introduced to the concept of a fair return standard in a staff report and by means of a presentation, discussing the fair return concept, analysis of three potential methodologies for calculating a fair return, and the legal necessity to select a standard (see Attachments 1 and 2). The RHC directed staff to solicit input from stakeholders on a potential fair return standard both in the form of written comments and by organizing stakeholder meetings.

#### **ANALYSIS**

Solicitation of written comments was initiated through posting on the CSFRA website, and by sending an e-mail to all subscribers of *MyMV*—Rental Housing Committee. Stakeholder meetings were held on June 12 with landlord advocates and on June 13 with tenant advocates.

## Written Comments

The following message was posted to guide the requested input:

*“Purpose of Stakeholder input:*

*As part of the implementation of the CSFRA, the Rental Housing Committee is considering the adoption of a fair return standard to be used when hearing individual landlord petitions for upward rent adjustments. One of the stated purposes of the CSFRA is to control excessive rent increases for rental units covered by the CSFRA while ensuring landlords receive a fair and reasonable return on their investment. The CSFRA identifies a number of factors that may be considered when calculating a fair return but does not identify or create a fair return methodology. A Fair Return Standard would provide clarity, transparency and understanding of what constitutes fair return by landlords, and public consistency, clear guidance to RHC and Hearing Officers when hearing petitions and consistency in the decisions.*

*The Rental Housing Committee wants to hear from the stakeholders and consider the input of both landlords and tenants as part of their decision making process. The Rental Housing Committee heard a presentation on the concept of a fair return standard on May 22, 2017.*

*Q1: Should the Rental Housing Committee adopt a specific standard to calculate fair return for petitions filed by landlords for upward adjustment of rent?*

*Q2a: If no, how would a petition be adjudicated in order to achieve a fair return that accomplishes the goal of the CSFRA if there is no standard?*

*Q2b: If yes, which of the following options should be the standard? (An explanation of these options is available in the Agenda Report and PowerPoint on the CSFRA website).*

- a. Maintenance of Net Operating Income – CPI Adjustment*
- b. Maintenance of Net Operating Income – Ratio Adjustment*
- c. Fixed Return on Investment*
- d. Other?*

*Q3: Please explain why you chose this standard.*

*Q4: Is there any other information you would like the Rental Housing Committee to consider in deciding whether to adopt a fair return standard?”*

This section contains a summary of the 44 submittals of written public input received. A complete set of written comments can be found in Attachment 3 to this staff report:

- Almost all present agreed that some form of fair return standard needs to be implemented and applied when landlords petition for individual upward rent adjustments.
- Two respondents indicated no standard should be adopted. One respondent suggested that instead, a petition process should take into account all allowable expenses to maintain habitability of the property and determine the amortization of these costs for full recuperation of these costs through rent increases. Another respondent suggested that a Vega standard be applied to situations where below-market-rate rent is charged, to allow for a rent similar to average rent as set by the HUD for Section 8 vouchers.

The following standards were suggested:

- MNOI-CPI adjustment standard, since it is being used in other communities and has proven to work well.
- Fixed Return on Investment standard.
- Other: Indexed Fixed Return on Investment (which takes an appraisal of fair market value instead of investment amount *times* inflation index *plus* fixed spread, reflecting work and risks involved in rental property ownership), Modified Return on Investment (also taking into account market value, but without the need for appraisal), recuperation of Market Value loss plus MNOI-CPI Adjustment. These standards all propose a fixed return standard of at least 7 percent to 12 percent.

Respondents also offered the additional feedback to the RHC:

- Smaller landlords operate under different circumstances than larger landlords, with usually lower than market-rate rents and nonrecoverable costs.
- Market value of properties has plummeted by at least 10 percent, since the CSFRA became effective.
- Recovering costs for building upgrades should be allowed.
- Good records management is needed, including compliance status.

## Stakeholder Meetings

Stakeholder meetings were held on June 12, 2017 with 15 landlord representatives and advocates present and on June 13, 2017 with 13 tenant representatives and advocates present. A copy of the staff memo and the presentation were made available on the CSFRA website prior to the meetings and were handed out during the meeting.

The summaries in this section contain the key issues raised at each meeting, organized by topic and not chronologically.

### Landlord Stakeholder Meeting:

All present agreed that some form of fair return standard needs to be implemented and applied when a landlord petitions for an individual upward rent adjustment.

Most agreed on the following two standards, using the appraised market-rate value of the rental property as of a recent relevant date:

1. Fixed Rate of Return: 12 percent [suggested as a percentage that would include recognition of a CPI component]
  - a. Would provide predictability and would require a less complex formula.
2. Fixed Spread Rate of Return: 8 percent to 12 percent plus CPI
  - a. Would still provide more predictability than the other MNOI formulas, but would also provide more flexibility in light of future changes in the market for rental property.

Those in attendance did not support either the MNOI with CPI adjustment or MNOI with ratio adjustment.

In support of this standard, the landlords explained that a fixed rate at a level such as 12 percent would be a more reasonable rate of return, because:

- The elements of risk and the amount of labor involved in owning and managing rental property should be acknowledged.
- This is the minimum rate of return when deciding whether to invest in rental property.

- Landlords want to maintain the quality of their rental property; they need a formula that continues to encourage this attitude.
- Landlords will be pulling out of the rental market if the rate of return is no longer reasonable. One result could well be loss of overall rental housing because existing rental properties might be purchased by investors for other, more profitable uses such as condominiums.

#### Suggestions Related to Capital Improvements Allowed under CSFRA:

- Establish a list of allowed capital improvements with an amortization schedule both for mandated repairs (shorter timeline) as well as for other necessary capital improvements permitted by the CSFRA (related to life span or useful life).
- Include more energy efficient/smart control replacements/upgrades and other “green” upgrades within the group of capital improvements allowed as necessary to maintain compliance with local codes.

#### Other Suggestions and Comments:

- There should be a process that allows a more specific formula for individual adjustments for landlords who have been charging below market rates to avoid them being penalized for doing so. One approach would be to adopt a “Vega” standard to set a minimum “market” rate. This standard allows for landlords who charged under market rate to charge at least a fair medium rent as established yearly by HUD and used for Section 8 vouchers.
- Perhaps give some benefit or credit to landlords who are willing to maintain the rent on some units at a below market type of rate.
- Establish a list of imputed expenses for landlords who do a lot of the day-to-day work themselves that would otherwise be an expense if performed by a contractor or other third party.
- Establish a simple pass-through process (with rubber stamp of approval) without having to go through formal hearings.
- A standard should be chosen that limits the scope of Hearing Officer decision-making discretion to avoid varying decisions based on who is selected to be the Hearing Officer on any specific case.

Tenant Stakeholder Meeting

All present agreed that a fair return standard needs to be implemented and applied when landlord petitions for individual upward adjustments are being reviewed.

According to all present, the standard MNOI plus CPI adjustment would be the best option for a specific standard.

Those in attendance supported neither the MNOI with ratio adjustment nor the Fixed Rate of Return on Investment. The latter is particularly disfavored. From the vantage point of the tenants, a Fixed Rate of Return formula works contrary to the purpose of the CSFRA to prevent excessive rent increases and it encourages speculation in the market. It does not recognize that landlords already benefit from the significant appreciation in the value of their rental property, especially if the base year is set at a recent or current date. The value of rental property has benefited in recent years from the significant infrastructure and vibrant community in Mountain View with high employment. These factors are much more important in determining the value of rental property than whether the rental income from the property is limited by rent control. Also, this standard may expose the City to legal liabilities.

The tenants explained the MNOI plus CPI adjustment is the most reasonable rate of return, considering:

- Its criteria are objective and predictable;
- It allows for an objective process that can be implemented by the HO or RHC;
- This standard is the one that has been adopted by the other rent control jurisdictions in California;
- It is a legally accepted standard; for example, by courts reviewing its use in other jurisdictions;
- CPI adjustments to the MNOI lower than 100 percent are possible; for example, courts have upheld an MNOI with an adjustment of 40 percent of CPI. Less than full CPI should be considered here to protect tenants, since landlords are already benefiting from a very high base year which would incorporate rent increases prior to 2015. Where landlords have not increased rents in 2015 and prior, they can seek adjustments pursuant to a “Vega” formula.

### Suggestions Related to Capital Improvements Allowed under CSFRA:

- Establish a list of specific capital improvements that would be allowed, with an amortization schedule for each, based on the useful life of the specific improvement. Only capital improvements that are truly required by current building codes should be allowed.
- Distinguish between one-time repair costs which justify a temporary short-term rent increase versus long-term capital improvements.
- Perhaps limit the time period for application of the capital improvement upward adjustment to the amortization period of the specific improvement, rather than allowing it be used for a permanent increase that would continue after the actual cost has been absorbed.
- Factor in the tax credits/rebates for certain capital improvements; for example, by giving an increase only for the net cost after these credits/rebates are deducted.
- Establish a list of imputed costs of labor when landlords perform their own work, with distinctions for the cost of unskilled types of labor versus work where the landlord possesses a license such as a contractor or plumber.

### Other Suggestions and Comments:

- Establish a base year earlier than 2015 (maybe 2010), since rents already were adjusted upward considerably by 2015. Alternatively, look at a base year based on an average of over a number of years, such as the five years between 2010 and 2015.
- “Vega” adjustments to the base year need to be allowed for landlords not charging market-rent rates. A specific formula for this adjustment needs to be developed.
- Introduce a similar type of Vega adjustment for tenants, if rents for base year are extremely high.
- Prevent loopholes in the petition process to circumvent the protections the CSFRA provides. For example, address loading major increases in operating expenses in the same year to justify a larger upward adjustment.

- Rents are not the only source of income for landlords; they are only part of the equation. Owning property is building wealth through market valuation. Market valuation had increased tremendously before 2015.
- Strong rules and regulations are needed regarding removal of rentals from the market under the Ellis Act: to avoid incentivizing landlords to remove rental units from the market.

### **STAFF RECOMMENDATION**

At the May 22, 2017 meeting, staff recommended the RHC adopt the MNOI fair return standard because it has been reviewed and accepted by the courts, it is widely used in California, it offers the simplest calculations for Hearing Officers and the RHC to use when hearing petitions, and it maintains individual landlords' net operating income as received prior to the CSFRA. Although staff is mindful that the landlord stakeholders disfavored this approach, the proposals from the landlord stakeholders appear counter to the intent and purposes of the CSFRA and will likely result in litigation.

### **DRAFT DEFINITIONS FOR CAPITAL IMPROVEMENTS AND NET OPERATING INCOME**

In response to the prior discussions of the RHC, staff has prepared draft definitions for both capital improvements and net operating income as these terms are not defined in the CSFRA and are factors to be considered by a Hearing Officer or RHC when hearing a petition (see Attachment 4). These definitions are based on review of other cities ordinance and regulations and they are being presented to the RHC during its discussion on the fair return standard to provide some context. Staff would also like direction from the RHC regarding these definitions as they are not being proposed for adoption at this meeting but will be presented at a future meeting.

### **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**

Once the RHC completes its deliberations on the fair return standard, staff will draft a fair return regulation and return to the RHC with all three components of the petition process (petition, hearing, and fair return standard regulations).



**PUBLIC NOTICING** – Agenda posting.

JLQ-AvD/7/CDD/RHC  
895-06-19-17M-E-2

- Attachments:
1. Fair Return Standard Memo RHC Meeting May 22, 2017
  2. Presentation Goldfarb Lipman Attorneys on May 22, 2017
  3. Copies of Submitted Public Input on Fair Return Standard
  4. Draft Definitions Capital Improvements/Net Operating Income
  5. Draft Amortization Schedule of Capital Improvements