MEMORANDUM

DATE: May 4, 2017

TO: Rental Housing Committee

FROM: Kenneth Baar, Consultant[1]

SUBJECT: **Fair Return Standards**

I. Introduction

This memo discusses fair return concepts and recommendations to the Committee for the selection of a fair return regulation.

Under price regulation, including rent control, constitutional property rights include the right to a "fair return." The courts have held legislatures (in this instance the Rental Housing Committee ("RHC")) have the power to establish fair return standards. However, the Courts are the ultimate arbiters of what constitutes a fair return. As a consequence, the drafting of fair return standards is strongly guided by judicial precedent.

Within this framework, rent stabilization ordinances provide for a petition process for adjudicating claims by individual owners that rent increases above the allowable annual rent increases and vacancy increases are needed in order to permit a fair return.

Section 1700 of the Community Stabilization and Fair Rent Act ("CSFRA") ensures Landlords a fair and reasonable return on their investment and guarantees fair protections for renters, homeowners and businesses. This guarantee of a fair rate of return is restated in Section 1711(m). As is standard in rent stabilization ordinances, the CSFRA allows Landlords to file a petition for an upward adjustment of the rent, to ensure a fair return when the annual allowable rent increases are not adequate,
The CSFRA provides that fair return determinations will be made by Hearing Officers and then may be appealed to the full RHC.

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[1] Baar's publications and testimony on fair return issues have been cited frequently in published California appellate courts opinions. He has prepared fair return reports for 18 California jurisdictions in fair return cases.

While the CSFRA provides for a right to a fair return and includes a list of factors to be considered and to be excluded in making fair return determinations, it does not provide a method for calculating fair return. Cities with rent stabilization laws which have been in effect for more than a few years and which have had a significant number of fair return petitions or a substantial number of rental units, have adopted a specific method for calculating fair return is either set forth in the ordinance or in regulations that have been promulgated pursuant to more general fair return requirements in the ordinance.

The RHC is charged with promulgating regulations to implement the CSFRA and must decide whether to adopt regulations setting forth the method to be used to calculate fair return when hearing a petition for an upward adjustment of the rent and whether to adopt a specific standard for determining what rent provides a fair return.

II. Background

A significant portion of the rent control ordinances in California (among apartment and mobilehome park space ordinances) contain a list of factors to be considered, without setting forth a specific fair return formula. Commonly these standards are supplemented by specific fair return formulas in the regulations used to implement the ordinances or charter provisions. While a list of factors without a specific standard may be constitutional, it is strongly recommended that the Committee adopt a specific standard to provide guidance to tenants, landlords and hearing officers and ensure consistency in decisions. In the absence of specific standards, fair return hearings commonly turn into legislative type hearings over what standard shall be used as well determinations of what rent increase is justified under a particular standard.

Judicial Guidance – General Directions Regarding Fair Return

No single type of fair return formula is required by the California Constitution[2]. In fact, "a governmental entity may choose to regulate pursuant to any fairly constructed formula[3],[4].

Fair return has been extensively litigated and debated (especially in cases regarding mobilehome park space rent regulations.[5]) Some guiding principles have emerged from these cases.

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[2] *Carson Mobilehome Park Owners' Assn. v. City of Carson,* 35 Cal.3d 184, 191 (1983)

[3] *Carson Harbor Village, Ltd. Carson Mobilehome Park Rent Review Board* (1999) 70 Cal. App. 4th 281, 290.

[4] In 1983, in *Carson Mobilehome Park Owners' Assn. v. City of Carson,* the California Supreme Court rejected a claim that a fair return standard in a rent control ordinance which left the selection of a fair return standard open ended and did not prescribe the use of a particular formula was overly vague. The Court stated: That the ordinance does not articulate a formula for determining just what constitutes a just and reasonable return does not make it unconstitutional.

As a general principle, the California Supreme Court has held that fair return is a "constitutional minimum" and the fact that a regulation reduces the value of a property does not render it unconstitutional.[6]

In *Galland v. Clovis*, the California Supreme Court stated:

> "Although the term "fair rate of return" borrows from the terminology of economics and finance, it is as used in this context a legal, constitutional term. It refers to a constitutional minimum within a broad zone of reasonableness. As explained above, within this broad zone, the rate regulator is balancing the interests of investors, i.e. landlords, with the interests of consumers, i.e. mobilehome owners, in order to achieve a rent level that will on the one hand maintain the affordability of the mobilehome park and on the other hand allow the landlord to continue to operate successfully. [cite omitted]. For those price-regulated investments that fall above the constitutional minimum, but are nonetheless disappointing to investor expectations, the solution is not constitutional litigation but, as with nonregulated investments, the liquidation of the investments and the transfer of capital to more lucrative enterprises."[7]

Another California Supreme Court opinion notes:

> "[a]ny price-setting regulation, like most other police power regulations of property rights, has the inevitable effect of reducing the value of regulated properties. But it has long been held that such reduction in property value does not by itself rend a regulation unconstitutional."[8]

The debate over what constitutes a fair return has been complicated by the fact the Courts have reached opposite conclusions on a fair return issue at times and the decisions contain some very general statements open to multiple interpretations. In one case a court explained:

> "Determining prices that will provide a fair return "involves a balancing of the investor and the consumer interests" [cite omitted]. ... One of these investor interests is a "return ... commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover should be sufficient to ... attract capital." ... a "court must determine whether the [regulation] may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly

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[5] Apartment and mobilehome park space rent regulations are guided by the same judicial doctrines and precedents regarding fair return.

[6] Other types of land use regulations such as zoning amendments commonly reduce property values.

[7] *Galland v. City of Clovis*, 24 Cal.4th 1003, 1026 (2001)

[8] *Fisher v City of Berkeley*, 37 Cal.3d. at 686.

> compensate investors for the risks they have assumed, and yet provide appropriate protection for the relevant public interests, both existing and foreseeable." [9]

One California Court of Appeal commented about the complexity of fair return issues and the lack of precision and sometimes conflicting nature of judicial guidance on the issues.

> "What appears at first blush to be a simple question of substantial evidence turns out to be something considerably more complex when one realizes that the formula for determining a 'fair return' is hotly debated in economic circles and has been the subject of sparse, scattered, and sometimes conflicting comment by appellate courts. In particular, only the broad outlines have been discussed in California decisions."[10]

The Courts have repeatedly reiterated the principle that a "range" of rents may be considered reasonable. One court explained:

> There is a range of rents which can be charged, all of which could be characterized as allowing a "just and reasonable" return. (See Hutton Park Gardens v. Town Council (1975) 68 N.J. 543 [350 A.2d 1, 15] [the terms "just and reasonable" and "confiscatory" are not precise formulations]; Power Comm'n v. Pipeline Co. (1942) 315 U.S. 575, 585 [86 L.Ed. 1037, 1049, 62 S.Ct. 736, 743] [there is a zone of reasonableness which is higher than a confiscatory rate].) Thus, many decisions by rent control boards will focus on the issue of where the requested increases fall within the range of possible rents -- all of which rents would allow the owner a return sufficiently "just and reasonable" as to not be constitutionally confiscatory.[11]

Judicial Guidance in Regard to Specific Standards

Apart from setting forth general principles in the past few decades, there has been extensive precedent in regard to particular types of fair return concepts and standards that have either been commonly advocated and/or adopted.

The Courts have Held that Return on "Value" Standards are Not Required and Are *Circular* in the Context of Rent Regulation

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[9] *Galland v. City of Clovis*, 24 Cal. 4th 1003 (2001), *Kavanau v. Santa Monica Rent Control Board*, 16 Cal.4th 761, 771-772 (1997).

[10] *Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com*. 16 Cal.App.4th 481, 484 (1993).

[11] *San Marcos Mobilehome Park Owners' Ass'n v. City of San Marcos,* 192 Cal.App.3d. 1492, 1502-1503 (1987)

In response to fair return claims made in the early 1980s, the Courts rejected the view that a fair *rate* of return on the ***value*** of a regulated property must be permitted in order to provide a fair return. The Courts have concluded that this type of standard is "circular" in the context of a rent regulation. In 1984, the State Supreme Court explained:

> "The fatal flaw in the return on value standard is that income property most commonly is valued through capitalization of its income. Thus, the process of making individual rent adjustments on the basis of a return on value standard is meaningless because it is inevitably circular: value is determined by rental income, the amount of which is in turn set according to value. Use of a return on value standard would thoroughly undermine rent control, since the use of uncontrolled income potential to determine value would result in the same rents as those which would be charged in the absence of regulation. Value (and hence rents) would increase in a never-ending spiral. "[12]

The Right to an Increasing "Net Operating Income"

Other guidance from the court has come to play a central role in fair return doctrine. A regulatory scheme "may not indefinitely freeze the dollar amount…profits without eventually causing confiscatory results. …If the net operating profit of a landlord continues to be the identical number of dollars, there is in time a real diminution to the landlord which eventually becomes confiscatory."[13] In other words, growth in net operating income must be permitted. This concept is critical because it sets forth a standard for fair return – whether or not allowable rent increases have been adequate to cover increases in operating costs and permit growth in net operating income.

Standards for Fair Rate of Return: Based on rent regulations in other jurisdictions and judicial precedent this memo discusses three fair return standards for the RHC's consideration and discusses judicial holdings that debt service must be excluded from consideration in fair return cases.

1. **Maintenance of Net Operating Income "MNOI" Standard**
   a. **MNOI Fair Return Standards Used by Other Jurisdictions with Rent Stabilization**

   The most widely adopted fair return standard has been maintenance of net operating income (MNOI). This standard has been adopted in either the ordinances or the regulations of Los Angeles, Oakland, Berkeley, Santa Monica, West Hollywood, and East Palo Alto and is in included in a substantial number of the

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[12]. *Id*. 37 Cal.3d.at 680, fn 33.
[13] *Id*. 37.Cal.3d. at 683.

mobilehome park rent stabilization ordinances in California. The MNOI standard is often applied under mobilehome park space rent stabilization ordinances, which list factors to be considered in determining what is a fair return, without setting forth a formula.

b. Description of the MNOI Standard
Under a MNOI standard, "fair return" (i.e, fair net operating income) is calculated by adjusting base year net operating income by a percent of the percentage increase in the Consumer Price Index (CPI) since the base year. For example, under a standard which provides for indexing the net operating income at 100% of the rate of increase in the CPI, if the net operating income was $100,000 in the base year and the CPI has increased by 70% since the base year, the current fair net operating income would be $170,000. (Under most MNOI standards, the year specified as the base year precedes the adoption of rent regulation. However, a more recent year may be used as the base year.)

The hypothetical example below illustrates how an MNOI standard works, under a standard which defines a fair return as the base period net operating income adjusted by 100% of the percentage increase in the NOI since the base year

In this example, the net operating income increased from $60,000 in the base year to $80,000 in the current year, a 33% increase, compared to a 50% increase in the CPI during this period This amount would be adequate to cover operating cost increases, but would not provide adequate growth in net operating income. Through an individual rent adjustment petition (with adequate documentation of income and operating expenses) the owner would be able to obtain an additional rent increase. The allowable increase would be $10,000 in order to raise the net operating income to a level that is 50% above the base year net operating income.

(Table 1)
Illustration of MNOI Standard

	CPI	Gross Income	Operating Expenses	Net Operating Income	Fair Return Allowable Rent Increase
Base Year	**100**	**$100,000**	**$40,000**	**$60,000**	
Current Year	**150**	**$150,000**	**$70,000**	**$80,000**	
Fair NOI (Base Year NOI Adjusted by the % increase in CPI)				**$90,000**	
Allowable Fair Return Rent Adjustment Fair NOI – Current NOI ***($90,000 – $80,000)***					**$10,000**

Jurisdictions with MNOI standards provide for indexing a base period of net operating income by varying percentages of the percentage increase in the Consumer Price Index, ranging from 40% to 100%. Berkeley and Santa Monica provide for 40% indexing and most mobilehome ordinances index by less than 100%. All of these indexing standards have been upheld by the Courts, which have consistently rejected the contention that indexing the net operating income by less than 100% of the percentage increase in the CPI is confiscatory[14]

[14] See *Berger v. City of Escondido*, 127 Cal.App.4th 1, 13-15 (2007); *Stardust v.City of Ventura*, 147 Cal.App. 4th 1170, 1181-1182 (2007); *Colony Cove Properties v. City of Carson*, 220 Cal. App.4th 840, 876 (2013)
The rationale for less than 100% indexing has been that the rate of increase in equity may exceed 100% of the rate of increase in the CPI even if the rate of increase in the overall value of a property is lower. For example, the value of an apartment building may increase by 20% from $1,000,000 to $1,200,000, but the increase in the equity of an owner who purchased with a 70% loan may increase from $300,000 to $500,000.
In the Colony Cove opinion, the Court stated:

> In *H.N. & Frances C. Berger Foundation v. City of Escondido*, the court explained why 100 percent indexing was not required for a rent controlled mobilehome park to achieve a fair return: "A mobilehome park's operating expenses do not necessarily increase from year to year at the rate of inflation, and . . . a 'general increase at 100% of CPI . . . would be too much if expenses have increased

The MNOI standard compares the net operating income with a prior (base year) net operating income rather than comparing the net operating income with the investment (purchase price). It is not an "intuitive" measure because it is not a real estate return measure that is commonly used by investors or by laypersons, but rather is a measure of fair return under rent regulation.

c. Rationale for Using the MNOI Standard

By providing for a pass-through in reasonable increases in maintenance costs to the extent these cost increases are not covered by annual allowable increases, the MNOI incentivizes maintenance of rental properties.

By providing for growth in net operating income, the MNOI standard allows for growth in the portion of rental income (the net operating income) that is available to pay for increases in debt service, to fund capital improvements, and/or to provide additional cash flow (net income). Therefore, the growth in net operating income also provides for appreciation in the value of a property. The standard provides all owners with the right to an equal rate of growth in NOI regardless of their particular purchase and financing arrangements. By measuring reasonable growth in net operating income by the rate of increase in the CPI, this approach meets the twin objectives of protecting tenants from excessive rent increases that are not justified by operating cost increases and increases in the CPI, and of providing regulated owners with a "fair return on investment."

Under the MNOI standard, it becomes the investor's task to determine what investment and financing arrangements make sense in light of the growth in net operating income permitted under the fair return standard.

d. **Judicial Acceptance of the MNOI Standard**

Courts have repeatedly upheld the use of an MNOI standard.[15] For example, one court found the MNOI standard was reasonable because it allowed an owner to

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at a lower rate.'" (*H.N. & Frances C. Berger Foundation v. City of Escondido [cite omitted]*.) Moreover, "the use of indexing ratios may satisfy the fair return criterion because park owners typically derive a return on their investment not only from income the park produces, but also from an increase in the property's value or equity over time." (*Ibid*.; accord *[cite omitted]* [explaining that "one reason for indexing NOI at less than 100 percent of the change in the CPI" is that "real estate is often a leveraged investment" in which "[t]he investor invests a small amount of cash, but gets appreciation on 100 percent of the value"]. *Id*.876-877.

[15] Most of the published appellate court opinions regarding fair return under rent regulation have involved mobilehome park rent regulations. This is a consequence of the facts that: 1) the mobilehome rent regulations are stricter – not allowing for increases upon vacancies, 2) some of the mobilehome rent ordinances have not allowed for annual across-the-board rent increases, thereby compelling owners to submit fair return petitions each time they desire to obtain a rent increase, 3) the stakes in

maintain prior levels of profit [16], and another concluded the MNOI formula is a "fairly constructed formula" which provides a ""just and reasonable" return on ... investment," even if an alternative fair return standard – such as the rate of return on investment standard (discussed further below) – would provide for a higher rent.[17]

In 2013, in *Colony Cove v. City of Carson*, the Court explained the rationale for an MNOI standard.

> The MNOI approach does not focus on how much the owner chose to pay for a rent-controlled property or how the purchase was financed. That fact does not render it constitutionally invalid. In Donohue v. Santa Paula West Mobile Home Park, where the rent control ordinance permitted adjustments to " 'maintain net operating income' " and specifically excluded from consideration " '[m]ortgage principal [and] interest payments,' " the court rejected the owner's facial challenge to the ordinance: "Numerous courts ... have acknowledged that the [MNOI] approach is constitutionally valid ... ," even though it ignores "certain expenses incurred by landlords" in determining NOI, including "land acquisition costs ... . " (Donohue v. Santa Paula West Mobile Home Park, supra, 47 Cal.App.4th at p. 1178; see Rainbow Disposal Co. v. Escondido Mobilehome Rent Review Bd., supra, 64 Cal.App.4th at p. 1172 [rent board need not reject MNOI merely because formula using owner's actual cost of acquisition yielded higher rent increase].) Indeed, the MNOI standard has been praised by courts and commentators for "its fairness and ease of administration" (Palomar Mobilehome Park Assn. v. Mobile Home Rent

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mobilehome park cases are substantial due to the size of mobilehome parks, typically involving from one to several hundred spaces. However, in regards to fair return issues the fair return concepts are interchangeable with the courts relying on fair return opinions from apartment cases in mobilehome park cases and vice versa.

16 *Oceanside Mobilehome Park Owners' Ass'n v. City Oceanside,* 157 Cal.App.3d.887 (1984); Also see *Baker v. City of Santa Monica,* 181 Cal.App.3d. 972 (1986)

17 In *Rainbow Disposal v. Mobilehome Park Rental Review Board*, 64 Cal. App. 4th 1159, 1172 (1998), the Court of Appeal stated: [the] MNOI approach adopted by the Board is a "fairly constructed formula" which provided Rainbow a sufficiently "just and reasonable" return on its investment. The Board was not obliged to reject [an] MNOI analysis just because an historical cost/book value formula using Rainbow's actual cost of acquisition and a 10 percent rate of return would have yielded a higher rent increase. Several California courts have approved the MNOI fair return standard (*Oceanside Mobilehome Park Owners' Ass'n v. City Oceanside,* 157 Cal. App. 3d. 887 (1984). See also *Baker v. City of Santa Monica,* 181 Cal. App. 3d. 972 (1986). California appellate courts upheld maintenance of net operating income fair return standards. In *Oceanside* the Court found that the standard was reasonable because it allowed an owner to maintain prior levels of profit. See 157 Cal. App. 3d. 887, 902-905 (1984). "The maintenance-NOI approach has been praised by commentators for both its fairness and ease of administration." See *Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com.*,16 Cal.App.4th 481, 486 (1993)

Review Com., supra, 16 Cal.App.4th at p. 486), because it " 'recognizes that in the rental housing market, ratios of rental income to value, equity, and gross income vary substantially among buildings. Therefore, rather than designating a particular rate of return as fair, [MNOI] standards pursue the best available option, which is to preserve prior [net operating income] levels' " (H.N. & Frances C. Berger Foundation v. City of Escondido (2005) 127 Cal.App.4th 1, 9 [25 Cal. Rptr. 3d 19]). The advantage of the MNOI approach over other methods of determining fair rent was further explained in Oceanside Mobilehome Park Owners' Assn. v. City of Oceanside, where the court stated: " 'Use of a return on value standard would thoroughly undermine 220 Cal. App. 4th 840, *868; …rent control, since the use of uncontrolled income potential to determine value would result in the same rents as ... would be charged in the absence of regulation. Value (and hence rents) would increase in a never-ending spiral.' " (Oceanside Mobilehome Park Owners' Assn. v. City of Oceanside, supra, 157 Cal.App.3d at pp. 899-900, quoting Cotati Alliance for Better Housing v. City of Cotati, supra, 148 Cal.App.3d at p. 287.) ….

Use of the MNOI formula " ' "avoids the necessity of having to undertake the administratively difficult (if not impossible) task of calculating equity and/or fair market value.["] ' " (Oceanside Mobilehome Park Owners' Assn. v. City of Oceanside, supra, 157 Cal.App.3d at p. 903.) Instead, it "permits park owners to obtain a just and [***60] reasonable return under general marketing conditions in any given year" and "reflect[s] the tenant's interest by giving the park owner an incentive to incur all reasonable expenses for maintenance and services." (Id. at pp. 902-903.)[18]

e. Adjustment of Low Base Year Rents

i. ("Vega" Adjustments) under the MNOI Standard

If an MNOI standard only permitted consideration of actual base year net operating levels, owners with very low base period rents may be locked into rents that do not reflect market conditions. This could occur because the current fair net operating income under the MNOI standard could be based on a CPI adjustment of a low base period net operating income.

However, this issue has been addressed by authorizing adjustments of base period rent which do not reflect market conditions in order to provide a level that reflects market conditions and provides a reasonable base period net operating income.

[18] 220 Cal. App. 4th 849, 869-870 (2013)

Such adjustments are known as "*Vega*" adjustments, because the right to such adjustments was established in the case of *Vega v. West Hollywood*.[19]) The *Vega* case involved an apartment owner who charged rents that ranged from $70 to $180 per month, compared to a city average which was three times higher. The rents of several units had not been raised in 15 to 20 years and the tenants had taken over responsibility for maintaining the property, from the 84 year old owner. The Court held the peculiar circumstances in this case, in addition to low base period rents, justified a base period rent adjustment.

The entitlement to an increase in the base rent depends on the existence of circumstances that prevented the base rent from reflecting market conditions."[20] Subsequent to *Vega*, an appellate court rejected the view that owners had a general entitlement to adjust base date rents which were below market rents and ruled that:

> **Respondents' position that "Birkenfeld and Vega establish a constitutional standard of general application to all historically low rent properties without exception" is not supported by the opinions in those cases, and we hold that there is no general entitlement to an increase in base date rents predicated on market conditions.**[21]

In the context of mobilehome park space rent controls the historically low rent issue was considered in *Concord Communities v. City of Concord*,[22] in 2001. In that casethe Court found a recent purchaser of the park met the "unique and extraordinary circumstances" test set forth in *Vega* based on the following facts:

1) the applicant was locked into below market rents set by the prior owner, who had "not raised rents in a consequential manner since 1985",
2) the current owner entered into a purchase contract just before the city adopted a rent regulation and
3) the current owner was not favored by particularly low property taxes of the previous owner.[23]

If the RHC elects to adopt an MNOI fair return standard, it should include a *Vega* standard.

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[19] 223 Cal.App.3d 1342 (1990); also, see *Concord Communities v. City of Concord*, 91 Cal. App.4th 1407 (2001)
[20] 24 Cal. App.4th 1730, 1737
[21] *Apartment Association of Greater Los Angeles v. Santa Monica Rent Control Board* [AGLA] 24 Cal. App.4th 1730, 1737.(1994)
[22] 91 Cal. App.4th 1407 (2001)
[23] *Id*., 91 Cal. App.4th at 1417-1419.

ii. Adjustments of Base Year Rents in Order to Provide a Minimum Net Operating Income/Rental Income Ratio in the Base Year

Under some ordinances or regulations containing an MNOI standard, if the base year NOI /Rental income ratio is below a designated percentage, projected base year rents are raised to a level which provides a projection of base year net operating income equal to a designed percentage of base year rental income (usually 50%).

In California, average net operating income/rental income ratios of apartment buildings are commonly in the 60% range. A ratio below 50% may be an indicator of low base year rents.

It is not recommended that a minimum ratio standard be used for determining whether the **current** year rents yield a fair return. Under a minimum ratio standard the fair rent is a multiple of the operating expenses. For example, if the minimum ratio is 50%, a fair rent is double the operating expenses. If such a standard was applicable to the current year, apartment owners would have an incentive to raise their expenses simply for the purpose of increasing net operating income. For example, under a minimum ratio standard of 50%, each one dollar increase in expenses would justify a two dollar increase in rents.

2. Fair Rate of Return on Investment Standard

A second type of fair return standard is a rate of return on investment (ROI) standard. From an intuitive perspective a rate of return of investment standard is often viewed as very logical. Furthermore, rent stabilization ordinances commonly include a provision stating that one of its purposes is to provide a fair "return on investment," which has sometimes been viewed as commanding the use of a rate of return on investment formula.

a. Description of Standard

In the context of rent regulations, the most common rate of return on investment formula has been:

FAIR RENT = OPERATING EXPENSES + X% of INVESTMENT

The allowable rent depends on what rate of return is considered fair. The following examples illustrate the outcomes under a 6% and a 9% rate of return on investment standard.

(Table 2)
Variations in Outcomes under Rate of Return on Investment Standard Depending on What Rate is Deemed Fair

OPERATING EXPENSES		X% OF INVESTMENT (fair net operating income)		FAIR RENT
$70,000	+	$72,000 (6% of $1,200,000)	=	$142,000
Or				
$70,000	+	$108,000 (**9%** of $1,200,000)	=	$178,000

Investment is defined as the total investment (purchase price + improvements) rather than only as the cash investment (total investment minus mortgage borrowing). The return is the net operating income (income before mortgage payments), rather than only the cash flow (net operating income left after mortgage payments).[24] In other words, the total return (net operating income) is compared with the total investment.

b. Use of Fair Rate of Return Standard in other jurisdictions
None of the California jurisdictions with apartment rent regulations use the "'*rate*' of return on investment" standard. However, this type of standard has been implemented under some mobilehome parks space rent stabilization ordinances.

c. Assessment of the Fair Rate of Return on Investment Standard
Rate of return on investment is commonly used as a measure of return by real estate analysts in evaluating real estate investments and is based on the commonly accepted concept that investors should always be permitted a fair rate of return on their investments. However, in the context of a fair return determination under a rent regulation, the use of a fair rate of return on investment standard in rent regulation works in a **circular** manner, and therefore cannot achieve the public policy objectives of providing a fair return to owners *and* preventing excessive rent increases and alleviating undue hardship for tenants.

In the market place, investment is determined by the expected returns. However, if the allowable returns in a rent-regulated environment are set at designated percentage of the amount invested in a property, the process of determining what is

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[24] In some jurisdictions a fair return on cash investment standard has been used. However, such standards discriminate among owners based on their financing arrangements. In three cases, a California Court of Appeal has ruled that consideration of debt service in a rent setting standard has no rational basis. *Palomar Mobilehome Park Ass'n v. Mobile Home Rent Review Commission* [San Marcos], 16 Cal.App.4th 481, 488 (1993) and *Westwinds Mobilehome Park v. Mobilehome Park Rental Review Board* [Escondido], 30 Cal.App.4th 84, 94 (1994), *Colony Cove v. City of Carson*, 220 Cal.App.4th 840, 871 (2013).

a fair return becomes circular. Under this type of standard, the investment (and, therefore, the investor) determines what return and, therefore, what rents will be fair.

A leading utility text identifies potential drawbacks using the purchase price (the "transfer cost") as the measure of investment in order to calculate fair return, in the context of a rent regulation.

> Transfer cost does not represent a contribution of capital to public service. Instead, it represents a mere purchase by the present company of whatever legal interests in the properties were possessed by the vendor. Even under an original-cost standard of rate control, investors are not compensated for buying utility enterprises from their previous owners any more than they are compensated for the prices at which they may have bought public utility securities on the stock market. Instead, they are compensated for devoting capital to public service. ...
>
> The unfairness, not to say the absurdity, of a uniform rule permitting a transferee of a utility plant to claim his purchase price was noted by Judge Learned Hand …
>
> The builder who does not sell is confined for his base to his original cost; he who sells can assure the buyer that he may use as a base whatever he pays in good faith. If the builder can persuade the buyer to pay more than the original cost the difference becomes part of the base and the public must pay rates computed upon the excess. Surely this is a most undesirable distinction. (Niagara Falls Power Company v. Federal Power Commission, 1943 ...)[25]

This reasoning has not been generally applied in rent control cases. However, federal courts in New York have concluded the return on investment approach does not make sense in the context of land use controls and rent regulation, noting how, the "regulated" investor can, in fact, regulate the allowable return under the rate of return on investment approach by determining the size of the investment. In a zoning case, the Court held:

> In addition to being inconsistent with the case law, appellants' [return on investment] approach could lead to unfair results. For example, a focus on reasonable return would distinguish between property owners on the

[25] Bonbright, Danielson, and Kamerschen, Principles of Public Utility Rates, 240-241 (1988, Arlington, Virginia, Public Utilities Reports, Inc.)

> amount of their investments in similar properties (assuming an equal restriction upon the properties under the regulations) favoring those who paid more over those who paid less for their investments. Moreover in certain circumstances, appellants theory "would merely encourage property owners to transfer their property each time its value rose, in order to secure ... that appreciation which could otherwise be taken by the government without compensation..." [cites omitted][26]

d. Limitations of Fair Rate of Return on Investment Standards

While the California courts have upheld the use of a rate of return on investment standard in principal, they have noted practical limitations of such an approach. In the *Fisher* case, the California Supreme Court noted the "mechanical" application of a return on investment standard could produce "confiscatory results in some ....cases" and alternatively could provide for "windfall" returns for recent investors, who paid high prices:

> At the same time that mechanical application of the fair return on investment standard may have the potential to produce confiscatory results in some individual cases [cites omitted] it is also recognized that the standard has the potential for awarding windfall returns to recent investors whose purchase prices and interest rates are high. If the latter aspect were unregulated, use of the investment standard might defeat the purpose of rent price regulation.[27]

On the other hand, if a "prudent" investor standard is used to try to curb abuses of a rate of return on investment standard by limiting what size investments will be considered in measuring what net operating income would be fair, the results also become circular. Under this approach, no rental increase can ever be justified because the investment may be considered "prudent" only if the current rents are already adequate to generate a fair return

Subsequent to the *Fisher* opinion, one Court of Appeal concluded the argument that a purchase cost may be viewed as high (imprudent) presents a "Catch-22.". The Court explained:

> ... it is a "Catch-22" argument. It posits that a prudent investor will purchase only rent-controlled property for a price which provides a fair rate of return at the then-current (i.e. frozen) rental rates. Having done so, however, the fair market value is frozen ad infinitum because no one

[26] *Park Avenue Tower Associates v. City of New York*, 746 F.2d. 135, 140 (1984).
[27] 37 Cal.3d. 644, 691 (1984)

should pay more than the frozen rental rate permits; and existing rental rates are likewise frozen, since the investor is already realizing a "fair rate of return".[28]

This duality of a rate of return on investment standards reflects the two sides of a circular concept. On the one hand, there is the view that rate of return on investment standards should not provide windfall returns to recent investors and should not provide an incentive to invest as much as possible for a property by providing a right to charge rents that will provide a fair return on any investment. On the other hand, is the view that an owner should be able to obtain a fair return on a prudent investment. However, if such an approach is adopted, an investment may be considered imprudent if the current rents do not yield a fair return on that investment. Additionally, this second viewpoint could lead to excessive rent increases and cause undue hardship to tenants, which would undermine the purpose of rent-stabilization programs.

e. Subjectivity in Measuring Fair Rate of Return under a Rate of Return on Investment Standard

Apart from the circularity issues associated with the use of a rate of return on investment standard, the calculation of the investment (the rate base) and the determination of an appropriate rate raises substantial issues.

In fact, rates of return vary substantially among properties, especially in times of significant inflation in property values. Therefore, the net operating income (and, consequently the rent) that will yield a fair return on an investment made decades ago might be a fraction of the rent required to provide the same rate of return on the investment of a recent purchaser.

When rate of return on investment standards are used, a host of options appear for measuring the investment and for the determination of a reasonable rate of return. In an adjudicatory process the fair return determination can turn into a mix and match process, in which alternate measures of investment and of a fair rate are "juggled" in order to obtain a desired result.

1. Selecting a Rate

The selection of an appropriate rate presents one set of problems. Varying theories and/or statistical constructions" about how to compute what is a "fair rate" can lead to widely differing outcomes. One commentary, in a textbook on utility rate

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[28] *Westwinds Mobile Home Park v. City of Escondido*, (1994), 30 Cal.App.4th. 84, 93-94.

regulation, even characterizes expert presentations on which particular rate is as "witches brews of statistical elaboration and manipulation":

> "... as we begin sheer disgust to move away from the debacle of valuation, we will probably substitute a new form of Roman holiday— long-drawn-out, costly, confusing, expert contrived presentations, in which the simple directions of the *Hope* and *Bluefield* cases are turned into veritable witches' brews of statistical elaboration and manipulation.[29]

In mobilehome park rent stabilization fair return cases, expert witness' projections of a fair rate of return have ranged from 4% to 12% (and even higher). Typically, in recent years, experts on behalf of mobilehome park owners have testified that a rate of return of about 9% is fair, while experts on behalf of cities and/or residents have contended that a fair rate is equal to the prevailing capitalization rate, now about 5 to 6%.[30] Adjudicators' (retired judges acting as arbitrators, rent commissions, trial courts, and appellate courts) conclusions about what rate is fair have ranged from 5% to 9%.

2. Measuring the Investment (The Rate Base)

The selection of a rate base raises another set of issues. Large variations in the outcome of a fair return calculation can also be generated by alternate choices in regard to the measure of the investment (rate base). Whether the original investment should be used as a rate base or whether that investment costs should be adjusted for inflation has been debated. Typically, long-term owners have investments that are low by current standards, while recent purchase prices have low rates of return relative to their investment. In periods of inflation in the prices of real property, the fair return becomes a function of the length of ownership. As a result, the rate of return on investments in apartment buildings with comparable rents and operating costs will vary substantially based on the purchase date of the building.

Some courts have held the investment should be inflation adjusted to reflect the real amount of the investment in current dollars. In *Cotati Alliance for Better Housing v. City of Cotati*, the court concluded that Cotati's return on investment standard was not confiscatory because "[t]he landlord who purchased property years ago with pre-inflation dollars is not limited to a return on the actual dollars invested; the Board may equate the original investment with current dollar values and assure a

[29] Shepard and Gies, *Utility Regulation, New Directions in Theory and Policy*, 242-243 (1966, New York, Random House)

[30] The prevailing capitalization rate is the net operating income/purchase price rate that new purchasers are obtaining at the outset of their investments. When the purchase price is inflation adjusted in the fair return analysis the fair return also becomes inflation adjusted.

fair return accordingly."[31] Commonly, if not usually, when rate of return on investment standards are used, the rent setting body has adjusted the original investment by inflation.

However, in other instances California courts have upheld the use of a standard under which investment was calculated in a manner virtually opposite to adjusting the original investment by inflation. Instead they have upheld "…taking the price paid for the property and deducting accumulated depreciation to arrive at a net historic value" See e.g. *Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com*. (1993), 16 Cal.App.4th 481, 487, the Court reasoned:

> [The park owner] argues that "historic cost" approach effectively transfers to tenants the use of $11 million in assets (the difference between the historic cost of the property and its current value) free of charge. It is true that in calculating a "fair" return, the City's proffered formula does not give park owners credit for any appreciation in the value of their property. Yet this is true any time a "fair return on investment" approach is used in lieu of a "fair return on value" formula. As we have explained .... both the United States and California Supreme Courts have approved the "investment" approach as constitutionally permissible. We are in no position to hold to the contrary by accepting Palomar's value-based test as a constitutional minimum. (Id. 16 Cal.App. 4th at 488)

The table on the following page illustrates how the wide range of possible rate bases and fair rates can lead to vastly diverging results under a rate of return on investment formula.

[31] 148 Cal.App.3d. 280, 289 (1983)

(Table 3)
Alternate Outcomes under Rate of Return on Investment Standard
(Investment x Fair Rate = Fair Net Operating Income)

Investment (Rate Base)	**Fair Rate**	**Fair Net Operating Income* (fair rate x investment)**
$2,000,000 original investment (e.g. 40 apartments x $50,000 / apartment unit)	**5%** capitalization rate (prevailing noi/purchase price ratio purchases in 2016)	**$100,000**
	7%	**$140,000**
	9%	**$180,000**
$1,200,000 original investment minus depreciation of improvements	**5%**	**$60,000**
	7%	**$84,000**
	9%	**$108,000**
$4,000,000 original investment adjusted by CPI	**5%**	**$200,000**
	7%	**$280,000**
	9%	**$360,000**

* Allowable rent = fair net operating income + operating expenses

Even if the original investment is inflation adjusted (adjusted by the percentage increase in the CPI since the purchase date), the outcome under a rate of return on investment standard depends heavily on whether an apartment owner purchased a property in a low or high cycle in real estate values. The hypothetical above illustrates how the standard may work. An owner who paid the same price for a property in 2010 (at the end of a flat cycle in apartment values) as an owner paid in 2000 (at the end of a surge in values) is permitted a much lower rent under standard, because the period of inflation used to adjust the purchase price is much shorter.

3. Rent Adjustments Based on Increases in Operating Expenses over the Prior Year

A third fair return methodology for setting allowable rents pursuant to individual rent adjustments provides for rent increases to cover operating cost increases since the prior year, which are not covered by the allowable annual rent increase. This type of standard is in effect under San Francisco and Oakland rent regulations. Recently Oakland supplemented this type of standard with an MNOI standard. San Jose is now reviewing proposed amendments to its fair return standards, which have contained this type of standard.

Under San Francisco's standard, rent increases above the amount authorized by the annual increase, which are based on operating cost increases, are limited to seven percent.[32] In the past four years, the number of petitions pursuant to this standard have ranged from 43 to 70.[33]

A concern about this type of standard is that it may enable apartment owners to obtain increases by bunching particular types of maintenance expenses which do not recur annually within a particular year.

The Exclusion of Debt Service Costs in Fair Return Standards

The CSFRA specifically excludes consideration of the "costs of debt servicing (including but not limited to principal, interest, and fees) for any debt obtained after October 19, 2015,"other than debt incurred to finance the costs of improvements necessary to bring the property into compliance with applicable local codes effecting health and safety, and where such capital improvement costs are properly amortized over the life of the improvements. (See Sections 1710(a)(3) & (a)(2)(C). It does not preclude nor require the consideration of the costs of debt service for any debt servicing of any debt incurred prior to October 19, 2015. However, within the past ten years in three published opinions the California Court of Appeal has held that setting allowable rent levels on the basis of mortgage costs has no rational basis.

Seven of the eleven apartment rent control ordinances in California (Los Angeles, San Jose, Oakland, Berkeley, Santa Monica, West Hollywood, and East Palo Alto) specifically **exclude** consideration of debt service in setting allowable rent levels, (except when the debt service is associated with capital improvements

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[32] S.F.Residential Rent Stabilization and Arbitration Board Rules and Regulations, Sec. 6.10
[33] See Rent Board, Annual Report 2015-2016, p. 11. San Jose's experience with this type of standard is not "instructive" because it allowed annual rent increases of 8% from the 1982 through 2015.

(Table 4)
Treatment of Purchase Mortgage Interest Expenses
Under Apartment Rent Stabilization Ordinances

Jurisdiction	*Consideration of Purchase Mortgage Interest Expenses*	*Limitations on Allowance of Debt Service Expenses*
Los Angeles	**Excluded**	
Oakland		Debt service pass-through repealed on April 1, 2014. Pre-repeal purchasers exempted from repeal.
Berkeley		
Santa Monica		
West Hollywood		
East Palo Alto		
Beverly Hills		
San Jose		Debt service pass-through repealed in 2016.

Most of the MNOI standards in mobilehome park rent stabilization ordinances preclude consideration of debt service. Under the other type of fair return standard that is sometimes used under mobilehome park rent stabilization ordinances, rate of return on investment, consideration of debt service is also excluded because fair return is measured by the return on the total investment, rather than just the cash portion of the investment. (Consistent with using this measure of return, the rate base for measuring the return is th total investment, and the calculation of the return is based on consideration of the whole return, rather than return net of mortgage interest payments.)
The ordinance of Oakland was recently amended to exclude consideration of debt service

Under the San Francisco, Los Gatos, and Hayward ordinances, increases in debt service may be passed through. However, under the San Francisco ordinance, increases based on debt service increases are limited to 7% and in buildings with six or more units are allowed only once every five years.

B. Rationale for Exclusion of Consideration of Debt Service

If debt service is considered, owners who make equal investments in terms of purchase price and have equal operating expenses, may be entitled to differing rents depending on differences in the size of their mortgages and/or the terms of their financing arrangements.

When increases in debt service can be passed through apart from other allowable rent increases, then the allowable rent is set at a level that both:

1) provides for reimbursement for the financed cost of purchasing a building, and

2) provides the allowable rent increases that would otherwise provide a fair return by providing for increases in net operating income which can be used to finance increasing debt service.

C. Court Treatment of Debt Service

In order to provide perspective on this type of exclusion, the following discussion explains the legal precedent and rationale for the standard policy of excluding consideration of debt service in calculating fair return.

As indicated, Courts have held there is no rational basis for consideration of debt service in a rent setting process.[34] Once court explained:

> "Assume two identical parks both purchased at the same time for $1 million each. Park A is purchased for cash; Park B is heavily financed. Under Palomar's approach, calculating return based on total historic cost and treating interest payments as typical business expenses would mean that Park A would show a considerably higher operating income than Park B. Assuming a constant rate of return, the owners of Park B would be entitled to charge higher rents than the owners of Park A. We see no reason why this should be the case."[35]

The same Court of Appeal reaffirmed its conclusion regarding the treatment of debt service expenses. "We have previously rejected the notion that permissible rental rates based on a fair rate of return can vary depending solely on the fortuity of how the acquisition was financed."[36] More recently, another Court of Appeal again affirmed the view that tying rents to individual owners' financing arrangements has no rational basis.

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[34] *Palomar Mobilehome Park Ass'n v. Mobile Home Rent Review Commission* [of San Marcos], 16 Cal.App. 4th 481, 488 (1993);
[35] Id, at 489.
[36] *Westwinds Mobile Home Park v. Mobilehome Park Rental Review Bd.*, 30 Cal.App.4th 84, 94 (1994)

> Apart from the inequities that would result from permitting a party who financed its purchase of rent-controlled property to obtain higher rents than a party who paid all cash, there are additional reasons for disregarding debt service. …debt service arrangements could easily be manipulated for the purpose of obtaining larger rent increases, by applying for an increase based on servicing a high interest loan and then refinancing at a lower interest rate or paying off the loan after the increase was granted. Alternatively, an owner might periodically tap the equity in a valuable piece of rental property, thus increasing the debt load. In any event, we discern no rational basis for tying rents to the vagaries of individual owners' financing arrangements.[37]

However, in an earlier case, one Court of Appeal held that consideration of debt service costs was required when it held that mobilehome park owners have a vested right to have their debt service considered if debt service was specifically allowed as an expense under the fair return standard in effect under an ordinance at the time the property was purchased.[38] Inthat case, The Court concluded the guidelines in effect when the mobilehome park was purchased created vested rights. In 1991, the same court reaffirmed this conclusion.[39] The applicable regulations in these cases may be distinguished from the provisions of the CSFRA, which do not require consideration of debt service., unless the exclusion from consideration of post Oct 2015 costs of debt service from consideration is viewed as tantamount to a compulsion to consider pre-Oct 2015 costs of debt service. However, such an interpretation would be counter the purpose of the ordinance to set rents in accordance with constitutional fair return standards.

RECOMMENDATION

As stated above, it is recommended that the RHC draft and adopt regulations that include a specific fair return standard. A specific fair return standard provides an objective methodology for consistent decisions.

Furthermore, the adoption of the maintenance of net operating income (MNOI) standard is recommended. The standard guarantees a right to rent increases which

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[37] *Colony Cove Properties v. City of Carson*, 220 Cal.App. 840,871 (2013), . Courts in other states have reached similar conclusions. In 1978, when considering the constitutionality of an apartment rent control ordinance, the New Jersey Supreme concluded that: "Similarly circumstanced landlords ... must be treated alike. Discrimination based upon the age of mortgages serves no legitimate purpose." *Helmsley v. Borough of Fort Lee*, 394 A.2d. 65, 80-81 (1978).

[38] *Palacio de Anza v. Palm Springs Rent Review Com.*, 209 Cal.App.3d. 116 (1989)

[39] *El Dorado Palm Springs, Ltd.v. Rent Review Com.*, 230 Cal.App.3d. 335 (1991)

cover operating cost increases and provide for growth in net operating income over a base year. The standard has been

1) approved in principle by the courts,
2) in challenges to individual decisions applying the standard its use has been consistently upheld, and
3) addresses the issue that has been considered by the courts to be determinative in fair return cases: whether or not growth in net operating income has been permitted.

In contrast, a rate of return on investment standard would lead to a situation in which rent regulations could be overridden with investments which are not justified by the current rents. While the courts have not rejected a rate of return on investment standard in principle, courts have repeatedly qualified the scope of its use (e.g. for example, by holding that there is no right to a fair return on excessive investments.) In practice rate of return hearings require the application of a particular rate, when there is no single rate that is fair and the opinions of courts and experts about what rates of fair have widely diverged.

An additional recommendation is that individual apartment owners' mortgage costs should not be considered under the fair return standard. The Courts have repeatedly held that differences in allowable rents based on financing arrangements have no rational basis. Conversely, owners should be entitled to the same rent increases whether they have small or large mortgages.