Study of the Apartment Rent Ordinance of the City of San José

Final Report

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Chapter 5

Individual Rent Adjustment Standards under the ARO and Constitutional Standards For Fair Return

Introduction

The purposes of this chapter are to discuss the standards under the ARO for authorizing rent increases in excess of the annual allowable across-the-board increases and to discuss constitutional fair return requirements.

A central purpose of individual rent adjustment standards under rent stabilization ordinances is to insure that apartment owners may obtain a fair return in cases in which the annual allowable rent increases are not adequate to provide a fair return. Under the type of fair return standard that is mostly widely used under rent stabilization ordinances, apartment owners have a right to rent increases which are adequate to cover increases in operating costs and provide for growth in net operating income. Questions that emerge include: how the individual rent adjustment standards in the ARO compare with constitutional fair standards, and the current and potential future impacts of the current standards.

Under the ARO, if a tenant objects to a rent increase in excess of the allowable annual increase, the apartment owner must justify the additional rent increase through the administrative hearing process on the basis of the individual rent adjustment standards. Under the current individual rent adjustment standards in the ARO, which are a type of fair return standard, owners may pass through increases in operating costs and debt service payments since the prior year to the extent these increases are not covered by the allowable annual increases and vacancy decontrols.

In order to consider issues related to the individual rent adjustment standard, it is essential to provide an explanation of:

1) fair return concepts from a constitutional, economic, and regulatory perspective,
2) the types of fair return standards used among jurisdictions with rent stabilization ordinances,
3) the rationale related to the use of different types of fair return standards , and the advantages and drawbacks in the context of rent regulation, and
4) what options the City has in regard to fair return standards and other standards.

The explanation is detailed because fair return concepts are multifaceted and in some ways operate in a manner that may be counterintuitive.

A. Constitutional Standards for Fair Return – Judicial Doctrine

Owners of rent regulated properties have a constitutional right to a "fair return." Under all rent stabilization ordinances, including the ARO, regulated owners may petition for a rent increase above the amounts authorized by the annual adjustment standard in order to present a claim that an additional increase is necessary to obtain a fair return. Cities may select the fair return formulas that apply to fair return petitions. However, the courts are the ultimate arbiter's of whether a fair return has been permitted.

In fact, very few fair return petitions have been filed under California's apartment rent control ordinances as long as vacancy decontrols have been in effect. This outcome has occurred because the combination of annual rent increase allowances and vacancy decontrols have allowed overall rent levels to increase by more than the CPI and therefore have been adequate to cover operating cost increases and to permit growth in net operating income.

1. General Guidance in Judicial Precedent

When peacetime rent stabilization ordinances were first introduced in California, towards the end of the 1970's and early 1980's, there was conflicting authority and substantial uncertainty about which fair return standard would meet judicial approval. In the face of this uncertainty, cities adopted rent stabilization ordinances that usually contained very general guidelines or statements of principle without setting forth a specific definition of fair return or a methodology for determining what constitutes a fair return. (Typically, these general provisions were supplemented with more specific regulations.)[1]

In 1983, in response to a legal challenge based on a claim that the fair return provisions in a rent control ordinance were overly vague, the California Supreme Court held that an ordinance does not have to contain a specific fair return formula and that the selection of a formula is a legislative task. 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. Rent control agencies are not obliged by either the state or federal Constitution to fix rents by application of any particular method or formula. As the United States Supreme Court has stated, "[t]he Constitution does not bind rate-making bodies to the service of any single formula or combination of formulas." [cites omitted] ... The method of regulating prices is immaterial so long as the result achieved is constitutionally acceptable. (cite omitted) ["it is the result reached not the method employed which is controlling"].)[2]

In 1997, the Court reiterated longstanding general principles for fair return that have been set forth in utility cases and rent control fair return cases, stating that fair return:

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[1] See e.g. Los Angeles Rent Adjustment Commission Guidelines, Sec 240.00 ("Guidelines to be Used by Hearing Officers for Determining A Just and Reasonable Return"); San Francisco Residential Rent and Arbitration Board, Rules and Regulations, Part VI ("Rent Increase Justifications")

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

> 1. "involves a balancing of the investor and consumer interests," 2.should be a "return ... commensurate with returns on investments in other enterprises having corresponding risks.", and 3. "should be sufficient ... to attract capital."[3]

In 2001, the Court held in *Galland v. Clovis* that the concept of "fair rate of return" is a legal term that refers to a "**constitutional minimum**", although the terminology is borrowed from finance and economics. The Court also stated that the return must "allow [the] Owner to continue to operate successfully."[4] (While *Galland* involved mobilehome park rent regulations, the Courts have applied the same fair return principles to apartment and mobilehome park rent stabilization.). In its opinion, the 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.[5]

While these concepts give localities and reviewing courts' broad discretion in formulating fair return standards, they leave uncertainty as to what outcomes would be considered reasonable and constitutional by the courts when reviewing "as applied" challenges to administrative rulings on individual petitions by Rent Boards or hearing officers. ("As applied" challenges are challenges to individual decisions, as opposed to "facial" challenges which involve a challenge to the overall validity of the law or regulations.)

Uncertainty as to what constitutes a fair return has been augmented by the fact that over a forty-year span appellate courts have reached diametrically opposite conclusions in regard to particular fair return issues. Furthermore, debate over the issue has been complicated by the fact that individual passages in court opinions, when taken out of context, can lend support to propositions at variance with the overall conclusions in those opinions.

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[3] *Kavanau v. Santa Monica Rent Control Board*, 16 Cal.4th 761, 772 (1997).

[4] As explained in the following portions of this chapter, the right to "operate successfully" has not included the right to cover mortgage indebtedness.

[5] 24 Cal.4th 1004, 1026 (2001)

2. Specific Guidance on Fair Return in Judicial Precedent

In 1984, in *Fisher v. City of Berkeley*, the State Supreme Court set forth some specific principles in in a lengthy discussion of fair return issues.[6]

a. Rejection of Claims to a Right to a Fair Return on "Value"

The Court held that a standard which defines a fair return as a fair rate of return on the ***value*** of a regulated property is "circular" in the context of regulation. Such a standard is circular because value depends on the allowable rent and, therefore, cannot be used to determine what rent should be allowed to permit a fair return.

The 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.[7]

It also held that a rent regulation is not invalid just because it reduces the value of properties and that: "Any price-setting regulation, like most other police power regulations of property rights, has the inevitable effect of reducing the value of regulated properties."[8]

3. The Right to an Increasing Net Operating Income

In *Fisher*, the Court also gave other guidance that has come to play a central role in fair return doctrine. The Court held that 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." [9] 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.

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[6] *Fisher v City of Berkeley*, 37 Cal.3d. 644, 679-686 (1984).

[7]. *Id.* 37 Cal.3d.at 680, fn 33.

[8] *Id.*, 37 Cal.3d. at 686.

[9] *Id.* 37.Cal.3d. at 683.

B. The Maintenance of Net Operating Income (MNOI) Standard

The type of fair return standard which is used to determine whether allowable rent increases have been adequate to cover operating cost increases and permit growth in net operating income, by comparing current current net operating income with a base year net operating income is known as a "maintenance of net operating income" (MNOI) standard.

Under this standard – known as a "*maintenance of net operating income" (MNOI)* standard – apartment owners are entitled to rent increases which are adequate to cover operating cost increases and to permit growth in net operating income. (In the context of fair return, "maintenance" of net operating income includes the concept of maintaining the value of the net operating income by providing for an inflation adjustment factor in calculating fair net operating income. Net operating income is income net of operating expenses; debt service is not considered as an operating expense.)[10]

Under MNOI standards, "fair return" (fair net operating income) is calculated by adjusting base year net operating income by a portion of or by one hundred 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. 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.[11]

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[10] "Net operating income" may be contrasted with "net income" which is income net of debt service payments.

[11] 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 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

(cont.)

The example below illustrates how MNOI standards work. In the hypothetical, rents have increased by $50,000 between the base year and the current year. During this period operating costs have increased by $30,000 and the net operating income has increased by $20,000, from $60,000 in the base year to $80,000 in the current year. 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 because the fair net operating income (the base year net operating income adjusted by the CPI increase) is $90,000.

Table 5.1
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**	
Current Year Fair Net Operating Income (Base Year NOI Adjusted by 50% increase in CPI)				**$90,000**	
Fair NOI – Current NOI ***($90,000 – $80,000)***					**$10,000**

The MNOI has been adopted by Los Angeles, Santa Monica, Berkeley, West Hollywood, East Palo Alto and is in effect under San Jose's mobilehome park rent stabilization ordinance.[12] In addition, this type of standard is set forth in a substantial portion of the mobilehome park rent stabilization ordinances in the State and is often applied under other mobilehome rent stabilization ordinances, which list factors to be considered in determining what is a fair return, without setting forth a formula. (Approximately ninety jurisdictions regulate mobilehome park rents.)

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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.

[12] San Jose Muni Code Sec. 17.22.470-580.

Rationale for the MNOI Standard

The MNOI standard works differently than rate of return standards because it 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 laypersons, but rather is a measure of fair return under rent regulation. The rationale for the use of this type of standard is set forth in the following discussion.

By providing for growth in net operating income, the MNOI standard provides 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 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.

In fair return challenges, appellate courts have repeatedly upheld the use of an MNOI standard.[13] In 1984, a Court of Appeal found that the MNOI standard was reasonable because it allowed an owner to maintain prior levels of profit. [14] In 1998, a Court of Appeal concluded that 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.

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[13] 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 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.

[14] *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)

> [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.[15]

Typically, the base year under an MNOI standard precedes the adoption of rent control based on the concept that rent levels which were set in the unregulated market provided a fair return. In the case of San Jose, the allowable annual increases, which have substantially exceeded the rate of increase in the CPI, clearly have been sufficient to allow owners to preserve pre-regulation levels (inflation adjusted) of net operating income.(See discussion in Chapter 6) In instances in which an MNOI standard is adopted years after the initial adoption of rent control, owners will not have not have records from earlier decades and will not have been on notice that such records would ever be relevant in a fair rent determination. Therefore, a recent year could be used as the base year. Owners should have income and expense records for the last three years, since under federal tax law, businesses are required to retain their business records for three years.

C. Rate of Return on Investment Standards

In *Fisher*, Court indicated that a return on investment standard could provide a fair return. However, its qualifications about such standards illustrated the difficulties with such an approach.

Rent ordinances commonly include a provision stating that their purpose is to provide a fair "return on investment." However, **none of the California jurisdictions with apartment rent regulations have used a "'*rate*' of return on investment" standard**. This type of standard has been implemented under some mobilehome park space rent ordinances.

When rate of return on investment formulas have been used in the context of rent regulations, the most common formula has been:

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[15] *Rainbow Disposal v. Mobilehome Park Rental Review Board*, 64 Cal. App.4th 1159, 1172 (1998)

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 standard.

FAIR RENT = OPERATING EXPENSES + X% of INVESTMENT

		(fair net operating income)
$70,000	+	**6%** of $1,200,000
$70,000	+	$72,000
		= $142,000
	or	
$70,000	+	**9%** of $1,200,000
$70,000	+	$108,000
		= $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).[16] In other words, the total return is compared with the total investment.

Circularity of the *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. Intuitively, the concept that investors should always be permitted a fair rate of return on their investments is commonly accepted . However, in the context of a fair return determination under a rent regulation, the use of a fair rate of return on investment standard works in a **circular** manner.

In the market place, investment is determined by the expected returns. If the allowable returns under a price regulation are set at designated percentage of the investment, the process of determining what is a fair return becomes circular. Under such an approach, h the investment (and, therefore, the investor) determines what return and, therefore, what rents will be fair.

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[16] 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 leading utility text notes the fallacies and circularity of using the purchase price (the "transfer cost") as the measure of investment in order to calculate fair return, in the context of a price 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 ...)[17]

This fallacy has been generally overlooked in rent control cases. However, federal courts in New York have concluded that the return on investment approach does not make sense in the context of land use controls and rent regulation. They have noted that under the rate of return on investment approach, the "regulated" investor is able to regulate the allowable return 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 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][18]

While the California courts have upheld the use of a rate of return on investment standard, they have noted the limitations of such an approach. In the *Fisher* case, the California Supreme Court noted that the "mechanical" application of a return on investment standard could produce

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

[18] *Park Avenue Tower Associates v. City of New York*, 746 F.2d. 135, 140 (1984).

"confiscatory results in some ....cases" and alternatively could provide for "windfall" returns of 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.[19]

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 type of approach the investment may be considered "prudent" only if the current rents are already adequate to generate a net operating income which is adequate to generate the rate of return which is considered reasonable. If this approach is followed no rental increase can ever be justified by the standard.

Subsequent to the *Fisher* opinion, one Court of Appeal concluded that the argument that a purchase cost may be viewed as high (imprudent) is 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 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".[20]

This duality in concepts in regards to rate of return on investment standards is not an accident. It reflects the inevitable appearance of 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, there 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.

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[19] 37 Cal.3d. 644, 691 (1984)

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

Subjectivity and Differences in How to Measure 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, there are substantial issues associated with the calculation of the investment (the rate base) and with the determination of an appropriate rate.

In fact, rates of return vary substantially among properties, especially in times of substantial 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 (among the alternate measures of investment and of a fair rate) aimed at obtaining a desired result.

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 regulation, 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.[21]

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%.[22] Adjudicators' (retired judges acting as

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

[22] 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.

arbitrators, rent commissions, trial courts, and appellate courts) conclusions about what rate is fair have ranged from 5% to 9%.

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). One principal issue within the return on investment debate has been over whether the original investment should be used as a rate base or whether that investment costs should be adjusted for inflation. 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. The problem with the return on investment approach is that 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 that 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*, a California Court of Appeal 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 fair return accordingly."[23] 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 appellate courts have upheld the use of a formula 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, in which 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

[23] 148 Cal.App.3d. 280, 289 (1983)

> 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 possible can lead to vastly diverging results under a rate of return on investment formula.

Table 5.2

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 2015)	**$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, the outcome under a rate of return on investment standard is heavily dependent on whether an apartment owner purchased a property in a low or high cycle in real estate values. The hypothetical below illustrates how the standard may work. An owner who paid the same price for a property in 2010 (at the end of 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 this type of standard, because the period of inflation used to adjust the purchase price is much shorter.

Outcomes Under Rate of Return on Investment Formula Using Inflation Adjusted Investment

Purchase Year	1990	2000	2010	2015
Average Purchase Price/Unit	59,000	107,000	106,000	191,000
Base Year CPI	132.1	180.2	227.469	258.572
Current CPI	258.572	258.572	258.572	258.572
Inflation (CPI) Adjustment of Original Purchase Price	96%	43%	14%	0%
Purchase Price /Unit CPI Adjusted	115,486	153,536	120,494	191,000
7% of Purchase Price	8,084	10,748	8,435	13,370
Annual Operating Expenses/ Unit	5,400	5,400	5,400	5,400
Allowable Annual Rent (7% of purchase price + operating expenses)	13,484	16,148	13,835	18,770
Allowable Monthly Rent	1,124	1,346	1,153	1,564

Furthermore, under a rate of return on investment standard, the amount of rent that is required to provide a fair return can actually decrease as a result of a downward cycle in values (and, therefore, investments.).

D. San José's Fair Return Standard

San Jose, Oakland and San Francisco have used a different standard than either the MNOI standard or the rate of return on investment standard in the formulation of their fair return standards. Under the standards of these jurisdictions, apartment owners are allowed to pass through increases in operating costs over the prior year to tenants. In San Jose, when a pass-through is being considered in an individual rent adjustment hearing, the allowable rent increase over the prior year's rent is set at an amount adequate to cover the allowable cost increases (for operations and maintenance, rehabilitation, and/or capital improvements) over the prior year plus 5%. As a result, this formula allows the for the possibility of obtaining a rent increase in excess of the annual allowable increase of 8%. These pass-through standards, including San Jose's

standard, do not provide for any consideration of what rent increases have occurred before the prior year and how those rent increases have compared with increases in operating expenses before the prior year.

The ARO provides for pass-throughs of increases in operating expenses, rehabilitation, capital improvements, and debt service.[24] The standard includes requirements that rehabilitation costs must be amortized over at least three years and capital improvements must be amortized over at least five years.[25] Increases in debt service interest are subject to a limitation to the interest associated with mortgage amounts that do not exceed 70% of the value of the property. The regulations contain detailed rules regarding consideration of increased debt service costs.[26] The pass-through amounts for each of the four provisions become part of next year's base rent.

While the ordinance and regulations provide for specific rules regarding rent increase allowances for cost pass-throughs, the ordinance also includes subjective directions that increases must be:

> reasonable under the circumstances, taking into consideration that the purpose of this chapter is to permit landlords a fair and reasonable return on the value of their property while protecting tenants from arbitrary, capricious, or unreasonable rent increases, and under certain circumstances, unjustified economic hardship...

and that consideration shall be given to the:

> reasonable relationship to the purposes for which such costs were incurred and the value of the real property to which they are applied.

As indicated, the City's standard provides for the possibility that petitions for large rent increases may be filed by recent purchasers of apartments, in order to pass-through increases in debt service over the debt service level of the prior owner.

San Francisco and Oakland's Pass-through Provisions

San Francisco's pass-through provision is similar to the San Jose standard, but San Francisco's standard contains two prominent limitations on pass-through increases, which are not contained in the ARO. Under San Francisco's pass-through allowance, increases are limited to seven percent and may not be imposed more than once every five years.[27]

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[24] Sec. 17.23.440

[25] Sec. 17.23.440.A.3.

[26] Sec. 17.23.440.B.and Apartment Regulations Sec. 2.030.03.

[27] San Francisco Rent Stabilization & Arbitration Board, Rules and Regulations, Sec. 6.10(d).

Oakland's pass-through provisions are also similar to those of San Jose, except that Oakland eliminated the debt service pass-through for newly acquired units on April 1, 2014. (This restriction is not applicable to units on which a bona-fide offer to purchase was made before that date.[28])

E. Treatment of Debt Service Expenses under San Jose's Ordinance and Other Ordinances and Issues Associated with Allowances for Debt Service Expenses

Treatment of Purchase Related Increases in Debt Service under the San Jose ARO

Under the San Jose ARO, apartment owners may pass through purchase related increases in interest payments of debt service (mortgages) over the interest payments of the prior owner. Under the ordinance and regulations pursuant to the ordinance, an investor can pass-through to tenants up to 80% of the increases over the prior owner's debt-service costs.[29]

The absence, prior to 2014, of petitions based on increases in debt service, may be attributable to a variety of reasons, including: the high turnover in apartment tenants which enabled owners to set a substantial portion of rents at market levels; the limited portion of units which could absorb additional rent increases beyond the annual increases of 8% authorized by the ordinance; landlord decisions to forego such increases; and/or an absence of general knowledge that such increases could be imposed. The debt service petitions that were filed in 2014 resulted in substantial increases in monthly rents ranging from $64 to $481, with an average increase of $199/month. In half of the cases, the increase was greater than $250/month.

The table below sets forth the size of the buildings, the number of petitioning residents, and the rent increase granted in each case.

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[28] City of Oakland, Rent Adjustment Board Regulations, Appendix A, Sec. 10.4.

[29] See Regulations Sec. 2.03.03 setting forth detailed rules regarding the treatment of mortgage interest payments. If the loan exceeds 70% of the appraised value of the property, the portion of the interest increase that can be passed through is limited to interest attributable to a 70% loan to value ratio

Table 5.3.
Debt Service Increase Petitions under ARO

Sale Date	Units	Units Served Notice of Rent Increase	Tenants Petitions Filed	Beginning Average Rent	Rent Increase Permitted (Debt-Service Pass-Through Amount)	New Average Monthly Rent	Percentage Increase
2008	8	2	2	$614	$481	$1,095	78%
2014	24	17	3	$1,120	$89	$1,209	8%
2015	8	7	6	$946	$193	$1,139	21%
2014	6	6	6	$598	$378	$976	65%
2013	12	12	11	$902	$300	$1,202	33%
2014	25	1	1	$675	$114	$789	17%
2015	7	4	1	$881	$335	$1,216	30%
2014	6	4	2	$1,298	$209	$1,507	16%
2015	6	5	1	$1,198	$327	$1,525	27%
2014	4	4	4	$1,191	$408	$1,599	34%
2015	4	4	4	$1,700	$255	$1,955	15%
2015	4	1	1	$1,920	$230	$2,150	12%
2014	6	4	1	$871	$64	$935	7%
2015	4	1	1	$2,295	$305	$2,600	17%
	124	**72**	**44**	**$1,158**	**$199**	**$1,357**	**27%**

Source: City of San Jose Housing Department, Rental Rights and Referrals Program

Assuming current volumes of apartment sales in San Jose continue, the number of instances in which there is a potential for the justification for debt service pass-through under the current standard is substantial. The records from one real estate data service includes data on the sales of 59 buildings with a total of 646 units that were sold in 2015 and 54 buildings with 1685 units that were sold in 2014. In most of those sales, the increase in price over the prior sale was $50,000/apartment unit or more and in a substantial portion cases the increase was over $100,000/apartment unit. Conservatively, assuming the increase in annual debt service is equal to 3% of the increase in the current purchase price over the prior purchase price, the additional debt service associated with a $100,000 increase in purchase would be equal to about

$300/month.[30] In cases in which the previous owner held a property for a significant length of time and paid off a portion or all of the mortgage, the difference between the new and old mortgages would be even greater.

Treatment of Purchase Related Debt Service Costs Under Other Rent Stabilization Ordinances

In contrast to San Jose's standard, six of the eleven apartment rent control ordinances specifically **exclude** consideration of debt service in setting allowable rent levels, except when the debt service is associated with capital improvements. Such exclusions exist in the ordinances of Los Angeles, Oakland, Berkeley, Santa Monica, West Hollywood, and East Palo Alto.[31] Beverly Hills ordinance does not authorize any rent adjustments for increases in debt service, but does not specifically state that debt service expenses are excluded.[32] Also, San José's Mobilehome Rent Stabilization ordinance excludes consideration of debt service costs, except when associated with the cost of capital improvements.[33]

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.

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[30] This projection is based on the assumption that 70% of the price, and, therefore 70% over the increase over the prior price, is financed by a mortgage and that the mortgage interest rate is 5%. Therefore, the increase in mortgage interest would be 5% of $70,000 =$3,500/year.

[31] Under Oakland regulation debt service pass-through were authorized until 2014.

[32] Beverly Hills Muni Code Sections 4-5-101 thru 4-5-707.

[33] San José Muni. Code Sec. 17.22.540.B.1. There are exceptions for refinancing required as a result of the terms of a mortgage in effect when the ordinance was adopted and for interest costs associated with the amortized costs of capital improvements.

Table 5.4
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 José	Included	Loan to Value Ratio Limited. Standards contain a list of factors to be considered, but not a formula for how they would applied.
Hayward		
Los Gatos		
San Francisco		Increase Limited to 7% of Rent. Buildings of 6 units or more permitted only once every five years

Source: Based on author's review of rent ordinances.

Most of the MNOI standards in mobilehome park rent stabilization ordinances preclude consideration of debt service. Under the other common type of fair return standard in 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 the total investment, and the calculation of the return is based on consideration of the whole return, rather than return net of mortgage interest payments.)

Judicial Doctrine Regarding Consideration of Debt Service Interest in Setting Allowable Rent Increases

As, noted, the general judicial doctrine regarding fair return, which has been frequently reiterated in California appellate decisions, has been that: "[r]ent control agencies are not obliged by either the state or federal Constitution to fix rents by application of any particular method or

formula."[34] However, in three cases the California Court of Appeal has held that consideration of debt service in a rent setting process has no rational basis.[35]

> 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.[36]

In a subsequent opinion, the same Court of Appeal reaffirmed its conclusion in regard to 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."[37]

In a recent (2013) opinion, a California Court of Appeal again affirmed the view that tying rents to individual owners' financing arrangements has no rational basis.

> 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.[38]

While the foregoing precedent holds that debt service should not be considered, in two cases around 1990, a California Court of Appeal carved out an exception to this rule. The Court held

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[34] See text at notes 3-4.

[35] *Palomar Mobilehome Park Ass'n v. Mobile Home Rent Review Commission* [of San Marcos], 16 Cal.App. 4th 481, 488 (1993);

[36] Id, at 489.

[37] *Westwinds Mobile Home Park v. Mobilehome Park Rental Review Bd.*, 30 Cal.App.4th 84, 94 (1994)

[38] *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).

that mobilehome park owners have a vested right to have their debt service considered if the debt service was an allowable expense under the fair return standard in effect at the time the property was purchased.[39] In *Palacio de Anza v. Palm Springs Rent Review Commission*, the Court concluded that the guidelines in effect when the mobilehome park was purchased created vested rights.

> [the guidelines]... created land-use property rights which became vested ... when the financing of the ... purchase was undertaken in reliance on the existing rent-control laws. In this sense, [the park owner] enjoys a situation or status analogous to that of one who had established the right to pursue a nonconforming use on land following a zoning change.[40]

In a subsequent case, in 1991, the same court reaffirmed this conclusion.[41] (Prior to these cases, the City Attorney's office of San Jose reached the same conclusion.[42]) A repeal of a debt service pass-through that made an exception for units purchased prior to the repeal would conform with the holdings in these two cases.[43]

Comment

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. As indicated, in three cases the California Court of Appeal has ruled that such a standard has no rational basis.

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 provides "reimbursement" for the financed cost of purchasing a building. This "reimbursement" is in addition to the otherwise allowable rent increases that would provide a fair return by providing for increases in net operating income, which can be used to finance increasing debt service.

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

[40] *Palacio, Id.*, 209 Cal. App.3d at 120.

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

[42] Memo from the Deputy City Attorney to the San José City Council, May 13, 1985 ("Limitations on Debt Service Pass Through – Retroactivity")

[43] On the other hand, it should be noted that under judicial doctrine applicable to land use law in general there has been no vested right to develop based on the fact that a land use was allowed under the zoning in effect when the purchase was made. Instead, vested rights have been limited to situations in which construction has been permitted and has commenced. Also, in a recent rent control case, a federal circuit court of appeal rejected the view that pre-rent control purchase arrangements could create a right to be free of subsequent regulations that may diminish the value of the property. *Rancho de Calistoga v. City of Calistoga*, 800 F.3rd 1083 (2015)