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700 South Flower Street, Suite 2995, Los Angeles, CA 90017
T: 310-581-0900 | F: 310-581-0910 | www.hraadvisors.com

DRAFT MEMORANDUM

To:	Honorable Mayor and City Council, City of Beverly Hills
From:	HR&A Advisors, Inc.
Date:	July 26, 2018
Re:	Maximum Annual Rent Increase Policies in the Beverly Hills Rent Stabilization Context

The City of Beverly Hills (the "City" or "Beverly Hills") retained HR&A Advisors, Inc. ("HR&A") to provide independent research and analysis about seven policy issues related to recently enacted changes to the City's Rent Stabilization Ordinance (the "RSO").[1] This Issue Paper addresses whether, and if so how, the City Council might consider amending the RSO or other sections of the City's Municipal Code to adjust its policies for regulating the maximum allowable annual rent increases for RSO units.

The Issue Paper begins with a general statement about the issue as it has arisen in the context of the RSO, describes the City's current policies on allowable rent increases, highlights related positions mentioned in public discussions about the RSO Amendments, and summarizes how this issue is addressed by 13 other California cities with rent regulation, based on a review of their ordinances and regulations and through discussions with several of those cities' representatives. The Issue Paper then presents data from various sources that have a bearing on the issue, including the U.S. Bureau of Labor Statistics ("BLS"), CoStar Group, Inc., and the Institute of Real Estate Management ("IREM"). Based on the information and data provided on this topic, the Issue Paper concludes with a set of plausible policy options for City Council, City staff, and public consideration.

Statement of the Issue

An essential feature of any rent regulation system is the maximum percentage and/or dollar amount by which rents are allowed to change each year. In setting the allowable change, local governments generally attempt to balance protecting tenants from excessive rent increases with the ability of housing providers to earn a "fair return," typically defined in terms of sufficient income to pay for ongoing costs of operating their apartment buildings.[2] Cities seek to strike this balance in different ways; there is no objectively correct mechanism, structure, or percentage by which rent increases can be regulated. Rather, there are many possible approaches to setting allowable rent increase amounts.

In addition to the basic structure and formula used to set allowable annual rent increases, some cities also allow costs for specified categories of capital improvements and/or operating expenses (e.g., cost of utilities

[1] Ordinance Number 17-O-2729, adopted in April of 2017 (the "RSO Amendments"). The City's Rent Stabilization Ordinance (the "RSO") regulations are included in Beverly Hills Municipal Code ("BHMC") Title 4, Chapter 5 ("Chapter 5") and Chapter 6 ("Chapter 6"). Tenants residing in RSO units subject to regulation under Chapter 5 are hereinafter referred to as "Chapter 5 Tenants;" and Tenants residing in RSO units subject to regulation under Chapter 6 are hereinafter referred to as "Chapter 6 Tenants."

[2] See Attachment A for an analysis of the standard of "fair return" and how it has been interpreted by the courts in a rent regulation context by Dr. Kenneth Baar, a lawyer and recognized expert on the subject.

and property taxes) to be passed through to tenants in the form of rent surcharges, which contributes to housing provider incomes. These provisions specify how housing providers may "pass through" eligible expense items, ranging from a relatively simple process that requires only submittal of evidence for increased costs (e.g. utility bills, government fee charges, etc.) and advanced notice to the affected tenant(s), to a more extensive process requiring independent review by a hearing officer, mediator, or some other governmental or third-party official, or a review body.

Another important consideration in setting the allowable annual rent increase is additional income housing providers receive when they raise rents to market rates if a unit is voluntarily vacated, which is known as "vacancy decontrol." California cities are required to permit vacancy decontrol under the provisions of the Costa-Hawkins Rental Housing Act of 1995 ("Costa Hawkins"),[3] although cities may impose controls on annual rent increases until that same tenant voluntarily moves.[4] According to the U.S. Census Bureau's American Community Survey 5-Year Estimates for 2012-2016, approximately 24 percent of renters in Beverly Hills moved into their unit within the past year,[5] suggesting (since nearly all multi-family rentals in the City are subject to the RSO) that nearly a quarter of all RSO rental units in the City may turnover in a given year, whereupon rents may be reset to market rate if vacated voluntarily.

One of the key changes of the RSO Amendments was to limit the ability for housing providers in Beverly Hills to increase annual rents for Chapter 6 tenants by *the greater of* the annual percent change in the CPI for Los Angeles-Riverside-Orange County ("LA Area CPI") or 3.0 percent, as compared with the 10.0 percent annual rent increase previously allowed by the original 1978 RSO.

During a series of professionally-facilitated dialogue sessions between Beverly Hills housing providers and tenants living in buildings subject to the RSO, following adoption of the RSO Amendments, tenants articulated a collective position that allowable annual rent increases under Chapter 6 should match the annual percentage change in the LA Area CPI, with a maximum allowable increase of 8.0 percent.[6] This proposed allowable rent increase provision would make Chapter 6 consistent with Chapter 5 policy. Tenants further argued that the allowable annual rent increase should be based on the LA Area CPI only, and not based on a negotiated fixed percentage or a "random number," and approval for rent increases should be contingent on maintaining at least minimum acceptable habitability standards.[7]

Housing providers articulated a collective position that the allowable annual increase should be a fixed percentage of either 6.0 percent or 5.1 percent with automatic passthroughs of utility costs to tenants, but without requiring formal approval from the City to do so.[8] A more recent communication from some housing

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[3] California Civil Code, sections 1954.50 to 1954.535.

[4] Proposition 10 on the November 2018 statewide ballot seeks to repeal Costa Hawkins.

[5] American Community Survey 5-Year Estimates, 2012-2016, Table B07013. Geographical Mobility In The Past Year By Tenure For Current Residence In The United States.

[6] City of Beverly Hills Human Services Division Memorandum, "Rent Stabilization Update," September 28, 2017, Attachment 1, p.22. http://beverlyhills.granicus.com/MetaViewer.php?view_id=40&clip_id=5787&meta_id=344485 ("Rent Stabilization Update")

[7] Ibid.

[8] City of Beverly Hills Human Services Division Memorandum, "Rent Stabilization Update," September 28, 2017, Attachment 1, p.21. http://beverlyhills.granicus.com/MetaViewer.php?view_id=40&clip_id=5787&meta_id=344485

provider representatives expressed a preference for a 7.0 percent maximum, although housing providers did not offer a basis for this number.[9] Housing providers also stated that they do not agree that CPI is an appropriate benchmark for allowable rent increases.[10]

The Current Beverly Hills Context

The City's RSO classifies tenants of buildings subject to the RSO as either Chapter 5 Tenants, who are those with original rent contracts of $600 or less per month and live in buildings constructed prior to September 20, 1978[11]; or Chapter 6 Tenants, who are those with original rent contracts that exceed $600 per month and live in buildings built before February 1, 1995. Under Chapter 5, housing providers may increase rents by *the lesser of* 8.0 percent or the percentage that results from taking the difference of the sum of the LA Area CPI for the 12 months preceding the most recent 12 months, and dividing that difference by the lesser of the two 12 month period sums. Under Chapter 6, housing providers may increase rents by *the greater of* 3.0 percent or the percentage change in the LA Area CPI between May of the most recent year and May of the preceding year. Chapter 6 limits vacancy decontrol for voluntarily vacated units only. Units vacated due to no-fault evictions must remain at the same rent for the next occupant. Additionally, both Chapter 5 and Chapter 6 limit rent increases to once every 12 months and permit housing providers to petition for rent increases beyond the allowable percentage amount through a rent increase application process, which is the subject of a separate HR&A Issue Paper.

Both Chapter 5 and Chapter 6 permit housing providers to pass through certain expense items without undertaking a rent increase application process, but the provisions are not identical. As shown in Figure 1, Chapter 5 and Chapter 6 both allow housing providers to pass through 90 percent of the cost of water penalty surcharges and the full cost of refuse fees imposed by the City, but Chapter 5 also allows housing providers to pass through specified amounts of capital expenditure surcharges, any government mandated improvements, utility expense surcharges, and property taxes (by approval of a hearing officer) at the time of the annual rent increase. If utilized, these passthroughs can result in rent increases that are greater than the annual percentage change permitted by Chapter 5 and Chapter 6, although the impact of these additional increases is difficult to quantify because the expenses are generally unique to each rental property. Relatedly, at this time, Beverly Hills is the only city that does not charge fees for required rent registration. Many cities that charge fees to housing providers for rent registration also allow housing providers to pass a portion of these fees through to tenants, pursuant to state law and judicial decisions.

[9] Rental Property Owners of Beverly Hills, "Letter to Mayor Gold and Councilmember Wunderlich," July 6, 2018.

[10] Rent Stabilization Update, *op. cit.*

[11] Beverly Hills Municipal Code 4-5-102.

Figure 1: Summary of Allowable Passthroughs for Chapter 5 and Chapter 6

Passthrough	Chapter 5	Chapter 6
Water Service Penalty Surcharge	90% of cost of surcharge	90% of cost of surcharge
Refuse Fee Surcharge	100% of cost of surcharge	100% of cost of surcharge
Capital Expenditure Surcharge	No greater than 4% of base rent	-
Improvement Expenses Mandated by Law	18% of cost including interest of value of capital	-
Utility Expense Surcharge	Difference between the percentage change in utility expenses and allowable rent increase	-
Property Tax Increase	5% of base rent for a maximum of 3 years; must be approved by hearing officer	-

Source: BHMC Title 4, Chapter 5 and Chapter 6

Comparison with Other Cities in California

Among the 14 California cities with residential rent regulation programs, including Beverly Hills, the range of approaches for setting maximum allowable annual rent increases includes the following:

- Setting allowable rent increases based on a specified percentage of annual change in the CPI;
- Setting allowable rent increases based on a specified percentage of annual changes in the CPI, but with a minimum and/or maximum percentage (i.e., a "floor and ceiling") by which rents may be increased annually regardless of changes in the CPI;
- Setting annual increases based on a specified percentage of annual change in the CPI, but subject to a fixed dollar amount each year up to which rents may be increased; and
- Setting a fixed percentage without reference to the CPI, up to which rents may be increased annually.

As shown in Figure 2, 12 of 14 cities, including Beverly Hills, use CPI to set allowable rent increases, and only two apply fixed percentages other than the CPI, both of which use 5.0 percent as the fixed maximum. Among the 12 cities that use CPI, seven base allowable rent increases on a fraction of the total annual percentage change in CPI, ranging from 60 to 80 percent. Like the Chapter 5 provisions, seven of the 12 cities that use CPI also have allowable maximum rent increases, ranging from five to 10.0 percent, and, like the Chapter 6 provisions, three have an allowable minimum increase, ranging from 2.0 to 3.0 percent. In addition to using the CPI, Santa Monica considers setting a maximum fixed dollar amount by which rents may be increased.

Figure 2: Comparison of Allowable Rent Increase Approaches and Percentages in California Cities with Rent Regulation

City	Fixed Percentage	Fixed Dollar Amount	CPI	Applicable Percentage of CPI	Allowable Minimum Increase	Allowable Maximum Increase[1,2]
Beverly Hills -- Chapter 5			✓	100%	-	8%
Beverly Hills -- Chapter 6			✓	100%	3%	-
Berkeley			✓	65%	-	-
East Palo Alto			✓	80%	-	10%
Hayward	✓			-	-	5%
Los Angeles			✓	100%	3%	8%
Los Gatos			✓	70%	-	5%
Oakland			✓	100%	-	10%
Mountain View			✓	100%	2%	5%
Palm Springs			✓	75%	-	-
Richmond			✓	100%	-	-
San Jose	✓			-	-	5%
San Francisco			✓	60%	-	7%
Santa Monica		✓	✓	75%	-	-
West Hollywood			✓	75%	-	-

[1] For cities that use CPI, this would be expressed as the lesser of the allowable maximum percentage increase or the relevant percent change in CPI.
[2] Does not include the allowable maximum increase with rent "banking."

Source: HR&A Advisors, Inc. and the individual cities

In addition to annual allowable increases, as noted above, cities with rent regulation also often enable housing providers to pass through some amount of specified expenses to tenants without undergoing a formal rent increase application process. Cities place a variety of restrictions on such expense pass-throughs, including the share of costs that may be passed through to tenants, how frequently expenses may be passed through, and what types of expenses may be passed through.

As shown in Figure 3, nearly two-thirds of California cities with rent regulation allow housing providers to pass through at least some of the costs of RSO registration and/or administration fees, and half allow some utility expenses to be passed through, often related to one-time water penalty surcharges or ongoing water assessments. A little over one-third of these 14 cities allow capital expenditures to be passed through without a formal petition process. It is more common that cities require capital expenditure passthroughs to be approved through a formal rent increase application process. Lastly, over 40 percent of these cities allow housing providers to pass through other expenses and fees, such a voter-approved indebtedness (e.g., municipal bonds and school facility bonds), special assessments (e.g., street lighting and maintenance districts and parcel taxes), property taxes in general, among others. However, the Santa Monica Rent Control Board voted in June 2018 to phase out the ability to pass through expenses on voter-approved indebtedness and

property taxes as these expenses have increased significantly in recent years, due to the combined effects of more such voter measures and increases in property sales with associated increases in assessed valuation, which figures in the cost of the voter-approved debt issues.[12] Santa Monica's new regulations eliminate property tax and voter-approved indebtedness surcharges for tenancies that begin after March 1, 2018, or if property ownership changes or if a property is reassessed, regardless of the duration of tenancy.[13] The regulations also limit these same surcharges to a maximum of $35 per unit for tenancies that began prior to March 1, 2018.[14]

Figure 3: Comparison of Generalized Allowable Pass-Through Expense Categories That Do Not Require a Rent Increase Application Process Among California Cities with Rent Regulation

City	Capital Expenses	Utilities	RSO Registration or Administration Fees	Other City-Imposed Fees
Beverly Hills -- Chapter 5	✓	✓		✓
Beverly Hills -- Chapter 6		✓		
Berkeley			✓	
East Palo Alto	✓	✓	✓	
Hayward		✓	✓	✓
Los Angeles[1]	✓	✓	✓	✓
Los Gatos	✓		✓	
Oakland	✓		✓	
Mountain View				
Palm Springs			✓	
Richmond				
San Jose				✓
San Francisco		✓		✓
Santa Monica			✓	✓
West Hollywood		✓	✓	
Percentage	**36%**	**50%**	**71%**	**43%**

[1] Allowable pass-through for Systematic Code Enforcement Program ("SCEP") fees, which are charged to all multifamily residential rental property owners in the City of Los Angeles, is included under the "Other City-Imposed Fees" column.

Source: HR&A Advisors, Inc. and the individual cities

[12] Santa Monica Rent Control Board Memorandum, "Administrative Item to amend Regulations 3105, 3106, 3108, 3109, and 3120, respecting surcharges, to conform these regulations with amendments previously adopted by the Board," July 12, 2018; https://www.smgov.net/uploadedFiles/Departments/Rent_Control/About_the_Rent_Control_Board/Staff_Reports/2018/Item%2012A%20Chapter%203%20Regulations.pdf

[13] Ibid.

[14] Ibid.

Consumer Price Index as a Benchmark for Allowable Annual Increases

As discussed in the preceding section, annual percentage change in the CPI is the predominant mechanism by which California cities with rent regulation systems benchmark allowable annual rent increases. The U.S. Bureau of Labor Statistics ("BLS") defines the CPI as "a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services."[15] The BLS categorizes the complete market basket that the CPI measures as "All Items," which includes subcategories for its various household cost components including "Rent of primary residence." However, the rent of primary residence subcategory necessarily only accounts for housing costs to the consumer (i.e. tenant) and does not include apartment operating costs that would be incurred by the housing provider. All 12 California cities that use CPI as a method for determining allowable annual rent increases refer to the CPI for All-Items for their respective metropolitan areas.

The premise for using the CPI to calibrate allowable rent increases is that it is the most widely used and accepted, most frequently updated (monthly) and most readily available measures of general price inflation.[16] Combined with the ability for housing providers to raise rents to market rates upon voluntary vacancy (i.e. "vacancy decontrol") and income from allowed pass-throughs, maintaining rents commensurate with changes in the CPI theoretically allows for housing providers to achieve levels of net operating income that are consistent with trends in annual operating expense price inflation over time, while also preserving the incentive for housing providers to maintain their properties to adequate standards.[17]

One alternative to using CPI as a benchmark for rent regulation is developing and annually updating a weighted index of annual apartment operating costs. However, a study prepared in 2016 for the City of San Jose points out that such operating cost studies are resource- and time-intensive, require the annual preparation of the study, annual hearings to consider the studies, and deliberation regarding the appropriate rent increase amount resulting from the data.[18] Moreover, previous operating cost studies have reached the same or similar outcomes that would have otherwise resulted from the application of the percentage change in CPI. Largely for this reason, Santa Monica abandoned this approach, which had been in use between 1979 and 2012, in favor of a percentage of the CPI and consideration of an annual dollar amount cap.[19]

CPI, Rent, and Operating Expense Data

As shown in Figure 4, annual percent changes in the Los Angeles area CPI have averaged 2.4 percent between 2001 and 2017, reaching as low as -0.8 percent during the Great Recession and as high as 4.5 percent. Had the current Chapter 6 provisions been in place over this time, the CPI percentage change would have only exceeded 3.0 percent in 2001 and from 2004 to 2008, meaning that rents would only have been

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[15] United States Bureau of Labor Statistics, "Consumer Price Index," https://www.bls.gov/cpi. There are two primary CPI measures: All Urban Consumers and Urban Wage Earners and Clerical Workers. Most rent regulation systems that reference the CPI use All Urban Consumers.

[16] Other plausible inflation indices that lack these multiple benefits include the Implicit Price Deflator, Producer Price Index and Personal Consumption Expenditure Deflator.

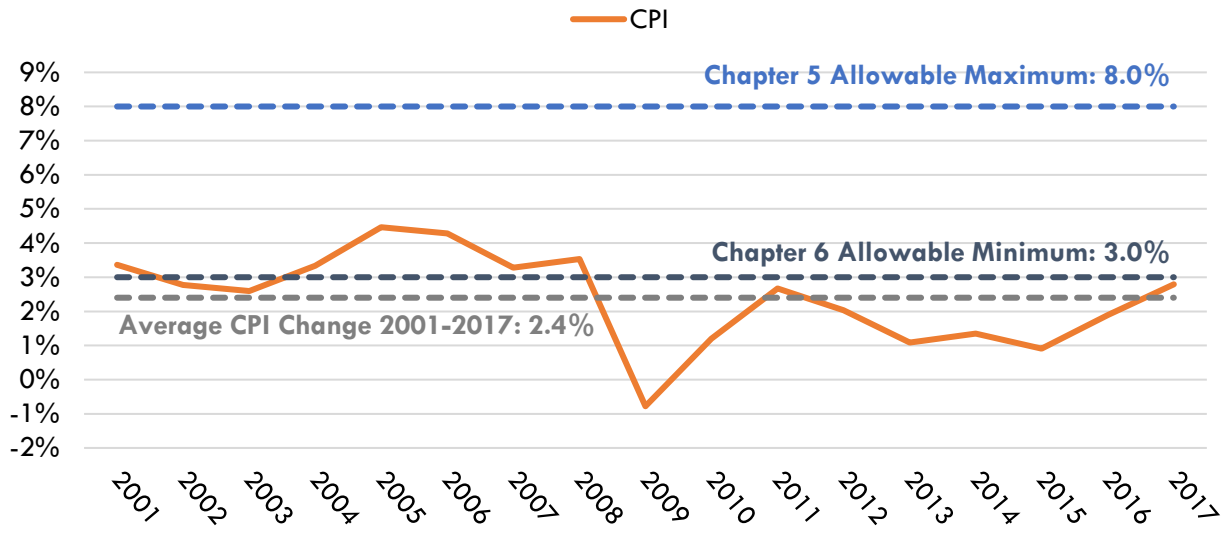
[17] Hamilton, Rabinovitz & Alschuler, *The 1994 Los Angeles Rental Housing Study: Technical Report on Issues and Policy Options*, p. 245.

[18] Economic Roundtable, *San Jose ARO Study,* April 2016, p. 86; https://www.sanjoseca.gov/DocumentCenter/View/55649

[19] City of Santa Monica Charter, Article XVIII, Section 1805 (a) and (b), amended by voter initiative, Nov. 6, 2012.

allowed to be increased by 3.0 percent in all other years between 2001 and 2017. Additionally, this also means that Chapter 5 rents were not allowed to increase at all in 2009, and the CPI has come only within 3.5 percentage points of the allowable 8.0 percent maximum under Chapter 5.

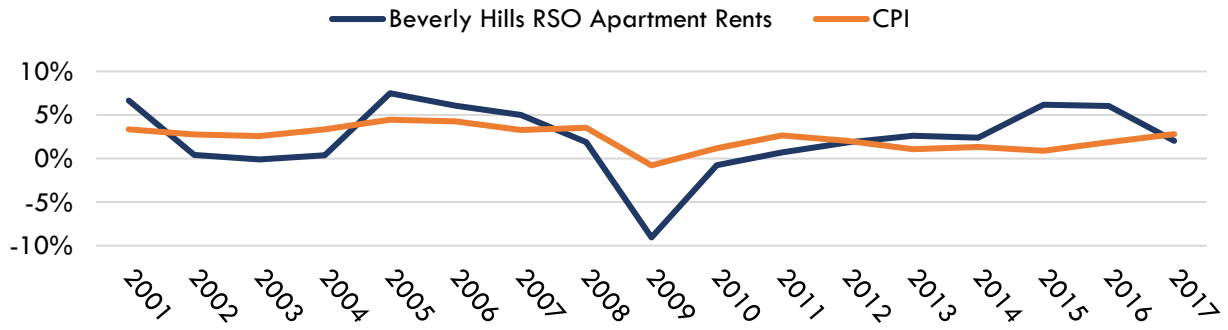
Figure 4: Average Annual Percent Changes in the Los Angeles-Riverside-Orange County CPI - All Items, 2001-2017



Source: HR&A Advisors, Inc; United States Bureau of Labor Statistics

As shown in Figure 5, annual increases in average per unit rents for Beverly Hills RSO units fluctuated more dramatically than changes in the CPI between 2001 to 2017, ranging from a steep -9.1 percent drop during the Great Recession to a 7.5 percent increase in 2005, but averaging a 2.3 percent annual increase over this period. Additionally, when accounting for only the years in which there was a positive percentage change in rents, the average annual increase was still just 3.5 percent. It should be noted that these rent data reflect both tenants who may have renewed leases and would therefore have had regulated rents, as well as the approximately 24 percent of units that turnover annually and may have leased at market rates pursuant to vacancy decontrol. There are no available data on how often individual housing providers sought and/or charged the then-maximum 10.0 percent rent increases for Chapter 6 Tenants prior to the RSO Amendments.

Figure 5: Average Annual Percent Changes in Beverly Hills RSO Rents Per Unit and the Los Angeles-Riverside-Orange County CPI - All Items, 2001-2017



Source: HR&A Advisors, Inc; United States Bureau of Labor Statistics; CoStar Group, Inc.

When considering regulating apartment rents by using percentage increases, however they are determined, it is important to account for the power of compounding, which can cause distortions in pricing for similar units, depending on the duration of tenancy. For example, Figure 6 shows the impact of growing Beverly Hills RSO and Los Angeles County rents at a fixed rate of 5.0 percent over 10 years. Average monthly Beverly Hills RSO rents per unit are currently $900 higher than the average for LA County as a whole. After 10 years of growth at 5.0 percent per year, this difference in rent would grow to nearly $1,470 per unit in 2028, a total net increase of approximately $570. Santa Monica's combination of a CPI-based allowable annual increase with a maximum allowable fixed dollar amount increase is intended to address the power of compounding so that lower and higher rent units receive relatively comparable rent protections on a nominal basis.

Figure 6: Illustrative Per Unit Rent Growth for Beverly Hills RSO and Los Angeles County Apartments at an Annual Rate of 5% Over a 10-year Period

Year	Beverly Hills	LA County	Difference
2018	$2,600	$1,700	$900
2019	$2,730	$1,785	$945
2020	$2,867	$1,874	$992
2021	$3,010	$1,968	$1,042
2022	$3,160	$2,066	$1,094
2023	$3,318	$2,170	$1,149
2024	$3,484	$2,278	$1,206
2025	$3,658	$2,392	$1,266
2026	$3,841	$2,512	$1,330
2027	$4,033	$2,637	$1,396
2028	$4,235	$2,769	$1,466
Total 10-Year Increase	**$1,635**	**$1,069**	**$566**

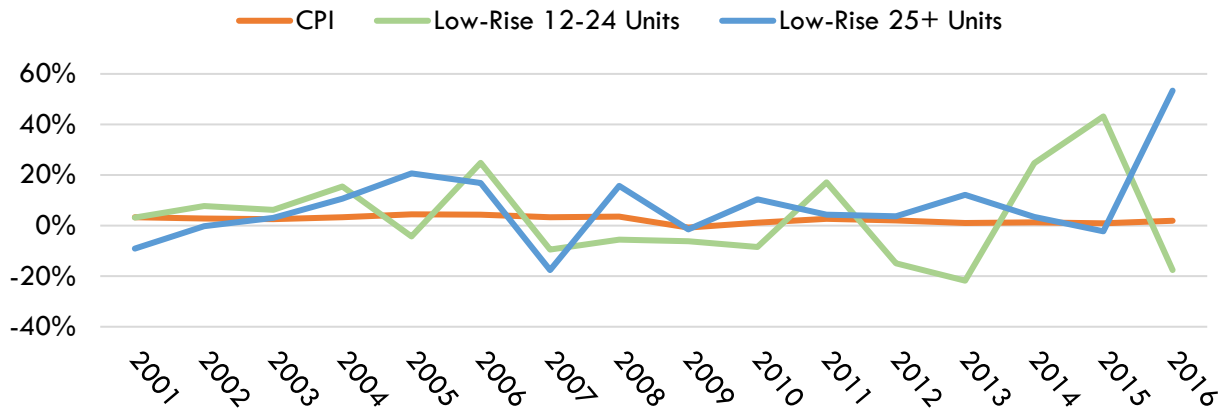
Source: HR&A Advisors, Inc; CoStar Group, Inc.

There is currently no independent, authoritative source for apartment operating expense data specific to Beverly Hills.[20] However, IREM provides operating expense trends for Los Angeles Metropolitan area apartments, categorized as properties that are low-rise (three stories or less) with 12 to 24 units or low-rise with more than 24 units.[21] As shown in Figure 7, annual percent changes in median operating expenses per square foot for apartments in the Los Angeles Metropolitan area have varied substantially year by year from 2001 to 2016, and increased by 4.0 percent on average for low-rise buildings with 12 to 24 units and 7.0 percent for those with more than 24 units.

[20] HR&A sought assistance from the Apartment Association of Greater Los Angeles ("AAGLA") to encourage its members with buildings in Beverly Hills to participate in a confidential apartment operating expenses survey designed by HR&A, but AAGLA declined to do so. HR&A's experience with similar surveys suggests that absent such industry encouragement, survey responses would be very low and non-representative.

[21] IREM also provides data for high-rise apartments, defined as four or more stores with an elevator, but these data are excluded here as these properties do not reflect Beverly Hills RSO housing stock and data for these properties are unavailable for several years.

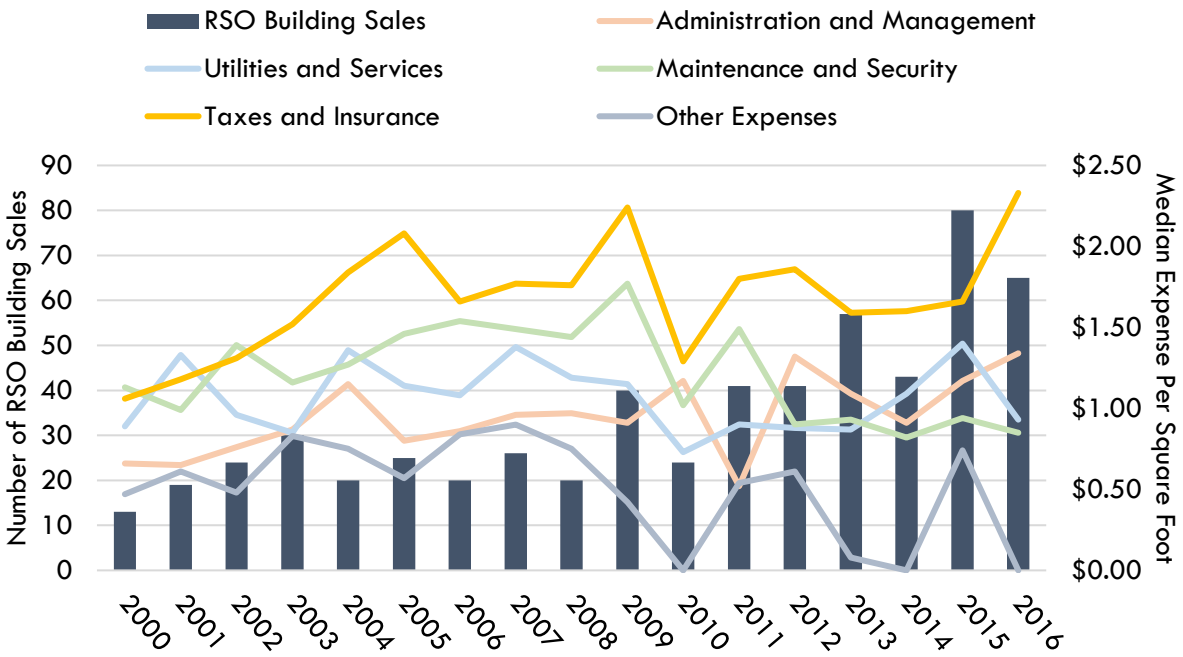
Figure 7: Average Annual Percent Changes in Los Angeles Metropolitan Area Median Apartment Operating Expenses Per Square Foot and the Los Angeles-Riverside-Orange County CPI - All Items, 2001-2016



Source: HR&A Advisors, Inc; United States Bureau of Labor Statistics; Institute of Real Estate Management

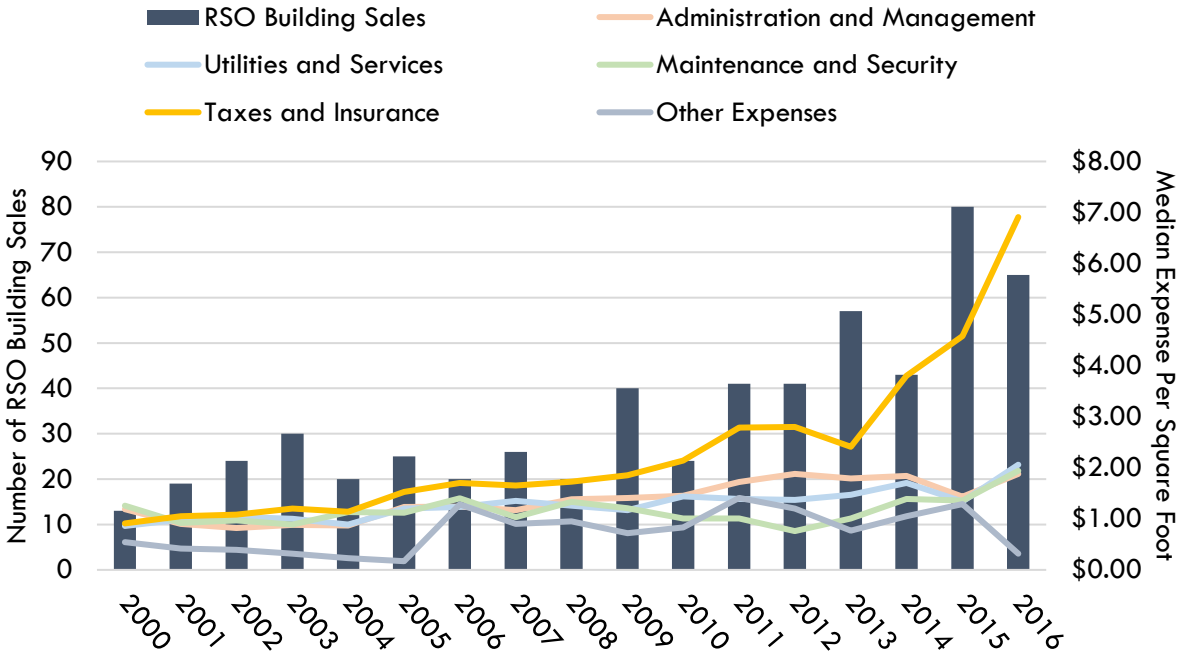
The recent spikes in the percentage change in operating expenses shown in Figure 6 are likely attributable to higher property taxes as a result of increased apartment building sales volume. Due to Proposition 13 passed by California voters in 1978, property taxes may not exceed 1.0 percent of a property's assessed value and assessed value may only increase by a maximum of 2.0 percent per year, unless a property is sold or if major physical changes are made like demolition, new construction, or a major remodel, at which point the property is reassessed at current market value. Therefore, a recent spike in the number of apartment building sales would result in increased property tax burdens for recently purchased apartment buildings, and a resulting increase in total operating expenses. As shown in Figures 8 and 9, median annual expenses per square foot for taxes and insurance for properties in the Los Angeles Metro Area increased as Beverly Hills RSO apartment building sales volume increased, while costs of all other apartment operating expense components for properties in the Los Angeles Metro Area have remained at relatively constant levels between 2000 and 2016, according to the IREM data. Importantly, as noted in the discussion of allowable passthroughs above, Chapter 5 allows housing providers to request rent increases of up to five percent of apartments base rents for a maximum of three years through a hearing officer process. Housing providers may also request from the hearing officer additional time to apply increased rents.

Figure 8: Beverly Hills RSO Apartment Building Sales and Change in Los Angeles Metropolitan Area Median Apartment Operating Expense Components Per Square Foot for Low-Rise Buildings with 12-24 units, 2000-2016



Source: HR&A Advisors, Inc; CoStar Group, Inc.; Institute of Real Estate Management

Figure 9: Beverly Hills RSO Apartment Building Sales and Change in Los Angeles Metropolitan Area Median Apartment Operating Expense Components Per Square Foot for Low-Rise Buildings with 25+ units, 2000-2016



Source: HR&A Advisors, Inc; CoStar Group, Inc.; Institute of Real Estate Management

Policy Options for Beverly Hills

As mentioned previously, there is no single objectively correct mechanism, structure, or percentage by which rent increases can be regulated. In summary, the foregoing information and data provide the following key considerations when weighing potential policy changes related to allowable rent increase and pass-through provisions in Beverly Hills:

- Both Chapter 5 and Chapter 6 allow limited pass-throughs without requiring housing providers to undergo a rent increase application process, but Chapter 6 pass-through allowances are more limited;
- Chapter 6 has allowable annual rent increase provisions that are more generous to housing providers than Chapter 5;
- Nearly all California cities with rent regulation use CPI, typically also applying an allowable annual maximum percentage or dollar amount increase;
- A majority of California cities with rent regulation charge RSO registration and/or administration fees, and allow housing providers to pass through a portion of these costs to tenants pursuant to state law and judicial decisions;
- Half of California cities with rent regulation allow housing providers to pass through some amount of utility expenses;
- Annual percent changes in CPI averaged 2.4 percent between 2001 and 2017, and increased as high as 4.5 percent over that time; and
- A recent increase in apartment building sales has resulted in an increase in property taxes as a proportion of apartment operating expense budgets

Considering these key points, HR&A suggests that there are at least seven plausible policy options that the City Council, City staff, and the public could consider when determining whether, and if so how, to address allowable annual rent increases (some of which could be combined with one another):

1. **No Policy Change:** In this case, the City would continue to allow annual rent increases of *the lesser of* the percent change in CPI or 8.0 percent for Chapter 5 Tenants and *the greater of* the percent change in CPI or 3.0 percent for Chapter 6 tenants.
    - **Advantages to housing providers:** Under current requirements, Chapter 6 housing providers would be assured of the legal ability to increase rents by at least 3.0 percent each year, and would be able to benefit from strong markets when the change in CPI exceeds 3.0 percent. Chapter 5 housing providers would maintain the ability to benefit from years when there are high increases in CPI up to 8.0 percent.
    - **Disadvantages to housing providers:** Chapter 5 housing providers would continue to rely on changes in CPI to increase rents, meaning that rents may not be allowed to increase in years when the CPI does not increase. In addition, housing providers may not be able to cover costs and could not use extreme rent increases to compel tenants to move voluntarily.
    - **Advantages to tenants:** Chapter 5 Tenants would continue to be subject to rent increases dictated by changes in CPI, potentially resulting in very low or no rent increases in some years. Chapter 6 Tenants would maintain a degree of certainty that future rent increases will be no lower than 3.0 percent, and may be higher in some years during strong economic periods when changes in CPI are above 3.0 percent.

- **Disadvantages to tenants:** Continuing to use only a percentage change as the benchmark for allowable rent increases will disadvantage tenants who already pay higher rent amounts due to the power of compounding and resulting in a disparity in nominal rent increases between tenants with currently low rents versus those who pay higher rents. Chapter 6 Tenants also would not receive the benefit of years when the CPI change is below 3.0 percent, as this is an allowable minimum rent increase that Chapter 6 housing providers may seek. With reduced maximum allowable annual rent increase, tenants can expect that their rent would be increased every year, when they may have not previously received annual increases when the maximum annual rent increase was 10 percent.

Administrative Considerations: This option would not create a need for additional staff time or other resources. However, as the RSO Amendments have been in effect for slightly more than a year, it is unknown whether housing providers would submit rent increase applications more frequently in future years, which could cause an increase in City costs.

2. **Set a maximum dollar amount by which rents may be increased annually, coupled with the existing allowable increases based on CPI:** In this case, the City would continue to allow annual rent increases of the lesser of the percent change in CPI or 8.0 percent for Chapter 5 Tenants and the greater of the percent change in CPI or 3.0 percent for Chapter 6 tenants, but would also annually establish a maximum dollar amount up to which rents could be raised.
    - **Advantages to housing providers:** Housing providers would continue to enjoy the benefits of the existing RSO provisions, and would potentially be able to charge up to the higher dollar amount in years when there might be a relatively low change in CPI.
    - **Disadvantages to housing providers:** In years when there is a high percent change in CPI, rent increases would be capped at the maximum dollar amount, inhibiting the ability for housing providers to benefit from the full increase in CPI, and also potentially narrowing the margin between operating revenues and expenses if most expenses continue to grow with CPI, and therefore may not cover operating costs.
    - **Advantages to tenants:** Tenants who might have otherwise experienced a rent increase due to a high change in CPI would benefit from a lower maximum allowable dollar amount increase, and it would potentially help reduce disparity in the increase in rents between tenants with comparatively high and low rents.
    - **Disadvantages to tenants:** Assuming housing providers seek to maximize rent increases, lower-rent paying tenants may be hit with a comparatively higher nominal rent increase than higher-paying tenants. Chapter 6 Tenants also would not receive the benefit of years when the CPI change is below 3.0 percent, as this is an allowable minimum rent increase that Chapter 6 housing providers may seek.

Administrative Considerations: This would necessitate a minimal amount of additional staff time to draft and support adoption of the RSO changes, and track rent increases and ensure that they comply with either the maximum dollar amount or change in CPI.

3. **Set a fixed annual maximum allowable rent percentage increase for Chapter 6 Tenants:** In this case, the City would establish a fixed maximum percentage up to which rents could be increased in any given year, and eliminate the minimum 3.0 percent increase and continue to use the CPI for Chapter 6 Tenants. The maximum allowable rent increases for Chapter 5 would remain the same.

- **Advantages to housing providers:** Depending on how high the fixed percentage is set, it could potentially allow housing providers with flexibility to achieve close to market-rate rents during strong economic periods, and would also provide some regulatory certainty that they could at least seek a given rent increase amount in future years.
- **Disadvantages to housing providers:** A low fixed percentage maximum might result in missed revenue-earning opportunities for housing providers during strong economic periods, while operating expenses may continue to increase.
- **Advantages to tenants:** A fixed maximum percentage would provide certainty that rent increases could not exceed a specified amount.
- **Disadvantages to tenants:** A relatively high fixed maximum percentage risks having the effect of limiting only the most extreme rent increases, and could potentially subject tenants to essentially market rate rent increases that they might have otherwise faced when seeking housing elsewhere. And, existing Chapter 6 pass-throughs would remain in place.

Administrative Considerations: This option would require a modest cost to draft and support enactment of the RSO changes, but would not result in any significant additional cost for staff time or other resources.

4. **Eliminate allowable maximum and minimum rent increases and set increases entirely on 100 percent or some fraction of percentage change in CPI:** In this case, the City would allow rent increases to fluctuate with changes in the CPI.
    - **Advantages to housing providers:** Housing providers could theoretically cover their operating costs if they rise commensurately with inflation, and they would enjoy high rent increases during strong markets.
    - **Disadvantages to housing providers:** Low percentage changes in the CPI for the Los Angeles area might not reflect an otherwise strong Beverly Hills housing market, meaning that housing providers would not be able to fully realize market opportunities.
    - **Advantages to tenants:** Given the average annual change in CPI of 2.4 percent between 2001 to 2017, tenants would likely be subject to fairly low increases over time.
    - **Disadvantages to tenants:** Fluctuations in CPI may be unpredictable, and could result in certain years that allow for high and unanticipated rent increases. And, existing Chapter 5 and Chapter 6 pass-throughs would remain in place.

Administrative Considerations: This option would require a modest cost to draft and support enactment of the RSO changes, but would not result in any significant additional cost for staff time or other resources.

5. **Allow more operating expense passthroughs for Chapter 6 housing providers without an application process:** In this case, the City would expand opportunities for Chapter 6 housing providers to pass through certain expenses like utility expense surcharges, capital expenditures, improvements mandated by law, property taxes, voter indebtedness, or others to tenants in the form of increased rents, with or without limits to what share of the respected expense may be passed through.
    - **Advantages to housing providers:** Housing providers would be able to leverage their operating expenses to increase rents, potentially beyond allowable percentage increase

levels. Creating consistency between Chapter 5 and Chapter 6 passthrough provisions would also provide a benefit to housing providers who have buildings with both Chapter 5 and Chapter 6 Tenants.

- **Disadvantages to housing providers:** Little to no disadvantage, other than potentially creating time-consuming processes to pass through expenses and fostering tension between housing providers and tenants.
- **Advantages to tenants:** Little to no advantages.
- **Disadvantages to tenants:** Tenants would be subject to higher rents than what the allowable increase might be.

Administrative Considerations: This option would require a modest cost to draft and support enactment of the RSO changes. More allowable pass-throughs would likely reduce the frequency of rent increase applications, resulting in a cost savings; however, cost savings would likely be offset by the additional staff time required to monitor pass-throughs.

6. **Limit operating expense pass-throughs, either by precluding them or by requiring formal rent increase application processes:** In this case, the City would reduce or eliminate allowable expense pass-throughs, or approve certain pass-throughs only through a petition process.
    - **Advantages to housing providers:** Little to no advantage.
    - **Disadvantages to housing providers:** Housing providers would have fewer opportunities to cover unexpected expenses, and would likely need to undergo a potentially time-consuming rent increase application process.
    - **Advantages to tenants:** Tenants would not face unexpected rent increases due to rises in expenses for pass-through expenses.
    - **Disadvantages to tenants:** Tenants may still be subject to rent increases resulting from successful rent increase application processes.

Administrative Considerations: This option would require more modest cost to draft and support enactment of the RSO changes. Reducing the categories of allowable pass-throughs would likely increase the frequency of rent increase applications, thereby creating potentially significant additional costs for staff time and other resources, although some of these costs could be offset by application fees.

7. **Require apartment buildings to meet habitability standards in order for housing providers to increase rents:** In this case, the City would establish new habitability standards that all RSO apartments must meet to permit respective housing providers to increase rents.
    - **Advantages to housing providers:** Little to no advantage, other than promoting property upkeep which would generally support property value and attractiveness to tenants.
    - **Disadvantages to housing providers:** Housing providers would potentially face costly improvements to their properties, and may be unable to afford improvements if they cannot commensurately increase rents.
    - **Advantages to tenants:** Tenants would enjoy both assured apartment quality standards, and be protected from rent increases if these standards are not met.
    - **Disadvantages to tenants:** Little to no disadvantage, other than potentially facing rent increases if housing providers are permitted to pass through the cost of improvements necessary to meet habitability standards.

Administrative Considerations: This option would require more significant cost to research, draft and support enactment of the RSO changes. It would also require substantial additional staff time and other resources to monitor and enforce property habitability standards, and associated rent increases, although some of these costs could be offset by inspection and application fees.

Attachment A
San Jose ARO Study Excerpt on the Standard of Fair Return

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

Final Report

April 2016

Kenneth Baar

Patrick Burns

Daniel Flaming

Underwritten by the City of San José, California

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:

[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.

[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)