Date: December 5, 2020

To: Rent Program Administrator

From: Michael Roush, Chief Assistant City Attorney
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Subject: Guidance Concerning Fair Return on Property

Background

Under the City's Rent Control, Limitations on Eviction and Providing Relocation Payments to Certain Displaced Tenants Ordinance, a landlord may file a petition for a "fair return on property," with the Program Administrator to request an upward adjustment of the Maximum Allowable Rent. Section 6-58.75 A, Alameda Municipal Code ("AMC"). In making an individual upward adjustment of rent, a Hearing Officer shall grant such adjustment only if such is necessary in order to provide the landlord with a "constitutionally required fair return on property". The Hearing Officer is not to determine a fair return solely by the application of a fixed or mechanical accounting formula but there is a rebuttable presumption that maintenance of a Net Operating Income for the Base Year, as adjusted for inflation over time, provides a landlord with a fair return on property. Section 6-58.75 G, AMC.

From time to time, landlords and tenants have asked for guidance as to what factors or criteria a Hearing Officer should consider or apply to determine a fair return on property.

As will be described below, determining a fair return on property is technical in nature and often complex. Although each Hearing Officer will make his or her own determination, this memo sets forth some guiding principles that may be helpful in this regard.

What should be kept in mind is that there is no inherent or direct correlation between what the market rent is for a rental unit and a fair return on property. Some landlords often conflate "market rate" with "fair return". That is, some landlords may believe that their rents are below market and therefore they are required to receive a rent increase to market rent in order to get a "fair return on property". But that is not the way fair return on property is to be determined.

First, the rent for a unit may well be below the market rent because the units being compared are not comparable as to age, size, amenities or level of maintenance. Second, even if the units were comparable, the rent for a unit may nevertheless be below the market, but, that fact alone, as discussed below, does not mean the landlord is entitled to a rent increase in order to receive a fair return on property. Third, current market rent reflects the scarcity of rental housing in the Bay Area region but that does not take into account that the rent an existing tenant is paying may have reflected market rent when the tenancy started. Fourth, the rent for a rental unit may be below market for other factors, such as the infrequency or absences of prior rent increases. Finally, some landlords may contend that their rents need to be increased to market because of debt service. Although a Hearing Officer may properly consider a landlord's "Costs of Operation" in determining a fair return on property, debt service is expressly excluded from the Costs of Operation and therefore cannot be a reason to increase rents to market. See Section 6-58.15 M, AMC.

Legal Framework for Determining A Fair Return on Property.

Courts have upheld various formulae or methods for granting rent increases when they are reasonably related to a proper legislative purpose and do not preclude a fair return or necessitate unconstitutional results.

Although no case has defined specifically the term “fair return”, the term has been described as one high enough to encourage good management, reward efficiency, discourage the flight of capital, is commensurate with returns on comparable investments but not so high as to defeat the purpose of preventing excessive rents. Accordingly, there is a range of rents that can be characterized as providing a fair return and a range of methodologies to arrive at such a return.

We have seen primarily two formulae utilized to determine a fair of return: (1) maintenance of net operating income; and (2) capitalization rate.

A. Maintenance of Net Operating Income Formula

In California the maintenance of net operating income (“MNOI”) formula or standard is the most often used for determining a fair return. Courts have praised the MNOI standard for its fairness and ease of administration and because it preserves for a property owner the net operating income prior to the adoption of rent control. Generally, this involves a three step process.

Step one is the determination of the Base Rent Year, which the Ordinance tells us is 2015 (the year before the Ordinance was adopted). The Ordinance also tells us that “Net Operating Income” is the gross revenues that a landlord has received in rent or any rental subsidy in the twelve months prior to serving a tenant with a notice of a rent increase less the “Costs of Operation” in that same 12 month period. “Costs of Operation” means all reasonable expenses incurred in the operation and maintenance of the rental unit such as property taxes, insurance, utilities, refuse removal, etc. As stated above, Costs of Operation does not include “Debt Service”, depreciation or “Capital Improvements”. “Debt Service” means the periodic payment due under any security financing applicable to the rental unit, for example, the mortgage (or in California, the deed of trust) payments.

Step two involves the calculation of the base rent year net operating income for 2015 as adjusted for inflation through the date of the notice of the rent increase.

Step three involves the calculation of the difference between the base rent year net operating income, as adjusted for inflation, and the most recent 12 months of net operating income. That difference is then divided first by the number of rental units and then by twelve. That number represents what the landlord is entitled to as a rent increase in order to receive a fair return.

To take a simple example, assume a landlord has a 10 rental unit building, the base rent year net operating income, as adjusted by inflation, was $100,000 and the NOI in the last twelve months was $98,000; the difference being $2000. The $2000 is divided first by 10 (the number of units in the building) and then by 12 (months), to yield $16.67. That would be the monthly rent increase to which the landlord would be entitled in order, under this formula, to receive a fair return.

Typically, when this information is provided in the hearing, expert witnesses, such as accountants, are involved so that the information can be scrutinized and, in some cases, questioned in order for the Hearing Officer to make an informed decision.

B. Capitalization Rate Formula

Another formula that is sometimes used to determine a fair return is called the capitalization rate formula. Capitalization rates look to the value of property compared to the property's net operating income and reflect, to some extent, an owner's "return on investment", i.e. what is the "return" on the owner's investment in, say, rental property. In very simple terms, a "cap rate" is the ratio of the net operating income to the price/value of the property. For example, a property valued at 2 million dollars yielding $10,000 in net operating income has a cap rate of 5%. There are companies that publish capitalization rates from sales of rental properties and appraisers will look at recent sales of rental property and use that information to determine a capitalization rate. Generally the more recent the sale is and the more localized the sale is, the more accurate the "cap" rate should be. The cap rate is then applied to the purchase price of the rental property, as adjusted by inflation, and compared to the net operating income. If the net operating income is less than the cap rate applied to the purchase price, as adjusted by inflation, then a rent increase may be warranted.

Using our previous example, assume the purchase price of the rental property, as adjusted by inflation, was $1.3 million (and we recognize that the purchase price of a 10 unit building is likely to be substantially more than $1.3 million). If the proper capitalization rate were 8%, it yields $110,000 which is more than the NOI ($98,000). The landlord would need a monthly increase of $100/month in order to receive a fair return. If, however, the proper capitalization rate were only 6%, it yields $80,000, which is less than the $98,000 and therefore, utilizing the cap rate method, no rent increase is necessary in order for the landlord to receive a fair return.

The critical factor, therefore, is determining the proper capitalization rate as the higher the rate, the more likely there will need to be a rent increase in order for the landlord to receive a fair return. As with the NOI formula, testimony concerning capitalization rates is often provided by expert witnesses, such as real estate appraisers or brokers or accountants.

Conclusion

The above is intended solely to provide an overview and guidance on fair return on property and there may be other methods that could be utilized to determine a fair return. Each petition is different and, as stated in the Ordinance, a fair return on property is not determined by the application of a fixed or mechanical accounting formula, keeping in mind, however, that the Ordinance must provide a landlord with a constitutionally required fair return on property.