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To: Chair Jeff Cambra and Members of the Rent Review Advisory Committee

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Subject: Guidance Concerning Fair Rate of Return and Financial Hardship to a Tenant

Background

Under the City's Rent Review, Rent Stabilization and Limitations on Eviction Ordinance, a landlord seeking a rent increase of more than 5% must request the Rent Review Advisory Committee ("the RRAC") to review the rent increase. A tenant may also request the RRAC to review a rent increase of 5% or less. Although either a landlord or a tenant may request RRAC review, that review occurs only when the Program Administrator and staff are unable to resolve the matter through discussion and/or informal mediation with the landlord and the tenant. As the RRAC is aware, most matters are in fact resolved through staff's efforts.

If, however, staff is not successful in resolving the matter and the rent increase is considered by the RRAC, the RRAC is vested with wide discretion in determining a fair resolution concerning the rent increase including "the financial hardship to the Tenant, the frequency, amount and the presence or absence of prior Rent Increases, ...the Landlord's Cost of Operations,...any increase or decreases in Housing Services since the last Rent Increase and the Landlord's interest in earning a just and reasonable rate of return on the Landlord's property." Section 6-58.85 B, Alameda Municipal Code.

Committee members have asked for guidance as to what factors or criteria it should consider or apply concerning two of these items: determining a just and reasonable rate of return on property and the financial hardship to the tenant.

As will be described below, determining a fair rate of return is technical in nature and often complex. Accordingly, unless the process before RRAC becomes more akin to the type of hearing that a Rent Dispute Hearing Officer would conduct—which would take an amendment to the Rent Review Ordinance and the duties of the RRAC, neither of which is under consideration--the RRAC's purpose will typically be better served by focusing on the other factors set forth in the Ordinance, rather than wrestling with the intricacies involved in the fair rate of return calculation. Unlike the concept of fair rate of return on which courts have opined in order to provide guidance, the concept of financial hardship to a tenant is more elusive and hence more subjective, depending on the financial situation of any particular tenant. Nevertheless, this memo sets forth some guiding principles that the RRAC may find helpful.

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 rate of return for a landlord. Some landlords will contend that their rents are below market and therefore they need a rent increase to market rent in order to get a fair return on investment. Not so. 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 must have a rent increase in order to receive

a just and reasonable rate of 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 but, as mentioned above, the RRAC may consider those factors in determining a fair resolution of the rent increase. Finally, some landlords may contend that their rents need to be increased to market because of debt service. Although the RRAC may properly consider a landlord's "Costs of Operation" in determining a fair resolution of the rent increase, debt service is expressly excluded from the Costs of Operation and therefore cannot be a reason to increase rents to market.

Legal Framework for Determining A Just and Reasonable Rate of 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 just and reasonable return or necessitate unconstitutional results.

Although no case has defined specifically the term "just and reasonable 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 just and reasonable return and a range of methodologies that can provide such return.

In our experience, we have seen primarily two formulae utilized to determine a just and reasonable rate 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 rate of return.

Certainly if the rental property has rental units that may not be the same, for example, a complex that has a mix of studios, and one-, two- or three- bedroom units, there could be a disproportionate impact concerning the rent increase for those units. That is, if the rent increase were, as in the example below, \$16.67/month, such increase as to a studio unit might not seem equitable when compared to a similar increase for a three bedroom unit if the base rent for the studio were less (as is likely) than the rent for a three bedroom unit. That impact, however, cannot be avoided because the landlord is entitled to a fair rate of return and the calculation does not lend itself to distributing the increase proportionately.

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 just and reasonable return on investment.

Leaving aside whether most landlords are prepared in the context of the current RRAC process to provide this kind of financial information, neither the Program Administrator nor the City has been authorized under the Ordinance to analyze this information. Therefore, the challenge for a tenant and the RRAC would be analyzing this information and the back-up documentation to determine if they support the landlord's rent increase. The tenant and/or the RRAC would need time to analyze the information provided by the landlord and, in some cases, would want to examine the supporting documentation to ensure that the data were accurate.

Accomplishing that task in the time allotted to each matter at a RRAC meeting is neither practical nor realistic. Typically when this information is provided, expert witnesses, such as accountants, are involved so that the information can be scrutinized and, in some cases, questioned, in order for the decision maker to make an informed decision. Accordingly, many tenants will not have the wherewithal or expertise to challenge this information. In addition, the rent program is currently not set up such that the Program Administrator/staff would question the information, as to do so would not only place the Administrator into potentially becoming an adversary of the landlord but also becoming an advocate for the tenant, contrary to the intent of the Ordinance.

B. Capitalization Rate Formula

Another formula that is sometimes used to determine a fair rate of return is called the capitalization rate formula. Capitalization rates derive from the sale of similar property and reflect, to some extent a "return on investment", i.e. what is the "return" on the owner's investment in, say, rental property. There are companies such as realtyrates.com that publish capitalization rates from sales of rental properties. In addition, 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 is 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 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. Without turning the RRAC process into an adversary process and/or requiring tenants or the Program Administrator to undertake the time and expense to develop information about capitalization rates, the landlords' data would be taken at face value that could lead to higher rent increases.

Determining the Financial Hardship to the Tenant

As stated previously, determining whether a particular rent increase is a financial hardship to a tenant will, more often than not, be somewhat subjective. That is, for many tenants, any rent increase will have a negative impact on a tenant's finances and that is especially true for tenants who are on a fixed income, who may have recently lost employment or who may be temporarily prevented from working due, for example, to an illness or disability. Accordingly, those factors may properly be taken into account when the RRAC is considering a rent increase. Moreover, one of the purposes of the Ordinance is to prevent rent increases that impose an undue burden on the finances of many Alameda residents. Taking a tenant's financial condition into account furthers that purpose.

On the other hand, the City Council, by adopting the Ordinance, and the voters in November 2016, by affirming the Ordinance, empowered landlords to increase rents by up to 5% annually as a matter of right. That is, a landlord who does not increase rent by more than 5% is not required to have the RRAC review such increase. Moreover, although a tenant may request such review, any decision of the RRAC or the City Council (on appeal) that imposes a rent increase of 5% or less is not binding on the landlord.

Nevertheless, the RRAC process provides an opportunity for the tenant to explain why a rent increase (even if 5% or less) is a financial hardship and provides an opportunity for the RRAC to suggest compromises, such as deferring the rent increase for a period of time, or phasing in the rent increase due to a tenant's temporary situation that would make paying the full amount of the rent increase at this time difficult. Some landlords may not be aware of a tenant's current situation and will be open to working with the tenant to arrive at a mutually acceptable resolution.

Finally, as with the fair rate of return analysis, the Ordinance does not provide the authority for the Program Administrator to undertake the analysis whether a rent increase is a financial hardship on a tenant. Such analysis would necessarily involve staff's examination of a tenant's private and sensitive financial (and perhaps medical) information which is clearly outside the ambit of the Program Administrator's services under the Housing Authority's contract with the City.

Conclusion

For the reasons expressed above, although the Ordinance does provide that the RRAC is to consider "the Landlord's interest in earning a just and reasonable rate of return on the Landlord's property", as a practical matter the RRAC current procedure does not lend itself handily to the kind of evidentiary process that typically accompanies how a decision maker determines "fair rate of return". The RRAC's consideration of individual rent disputes already consumes substantial time—most often 45 minutes per case—and if fair rate of return were to be added to the equation, the RRAC would need to hold many more meetings and be prepared to spend several hours on each case. (As stated above, this would also take an amendment to the Rent Ordinance and the duties of the RRAC.) Fortunately, the Ordinance does provide for a number of other, non-exclusive, factors that the RRAC may consider in determining a fair resolution of the rent increase. We suggest that the RRAC continue to focus on those factors, including the financial hardship to the tenant (notwithstanding that such factor may be somewhat subjective).

Moreover, for those rent increases above 5% for multi-family rental units built before February 1995, the landlord, if dissatisfied with the RRAC's resolution of the rent increase, may file a petition and have the rent increase heard by a Rent Dispute Hearing Officer. That forum will provide the landlord and the tenant with the time and opportunity to scrutinize closely the documentation that a landlord may provide in order to support the landlord's position that the rent increase is necessary to receive a fair return on property.

We will be present at the RRAC meeting on October 2 and will be prepared to answer any questions the Committee members have on these topics at that time.