

Item 7.4: Consider a Fair Return Standard

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Fair Return Standard

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Discussion of Fair Return Standards

Presented to: Rental Housing Committee
City of Mountain View

Presented By: Goldfarb & Lipman LLP
Special Counsel

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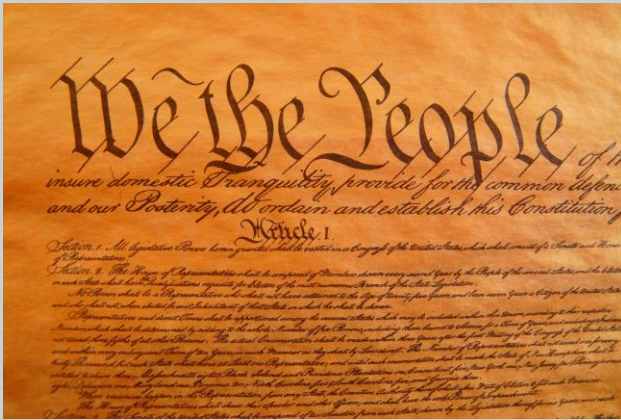
Fair Return Standard – Agenda

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1. Fair Return: What & Why?
2. Two Fundamental Equations
3. Three Fair Return Standards
 - A. Maintenance of Net Operating Income (MNOI) with Consumer Price Index (CPI) Adjustment
 - B. MNOI with Ratio Adjustment
 - C. Fixed Rate of Return
4. Example Calculations
5. Questions

1. Fair Return: What & Why

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1. Fair Return: What & Why

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Government may not **take** private property without **just compensation**.

Judicial Interpretations

Price regulations would take property **if** the regulations preclude an owner from earning a reasonable and fair return.



2. Two Fundamental Equations

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Net Operating Income (NOI)

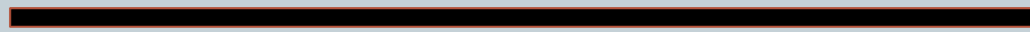
Gross Income (Rent)	—	Operating Expenses	=	Net Operating Income
\$100,000	—	\$40,000	=	\$60,000

2. Two Fundamental Equations

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Rate of Return

Net Operating Income (NOI)



Investment

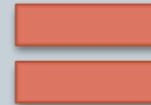


Rate of Return

\$60,000



\$1,000,000



0.06 or 6%

3. Three Fair Return Standards

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1. Maintain Net Operating Income (MNOI) – Consumer Price Index Adjustment

- Change in CPI: Base Year to Petition Year

- Calculate Base Year NOI

$$\text{Base Year NOI} \times \text{Change in CPI} = \text{Petition Year NOI}$$



Table 1. Consumer Price Index for All Urban Consumers (CPI-U): Indexes and percent changes for selected periods

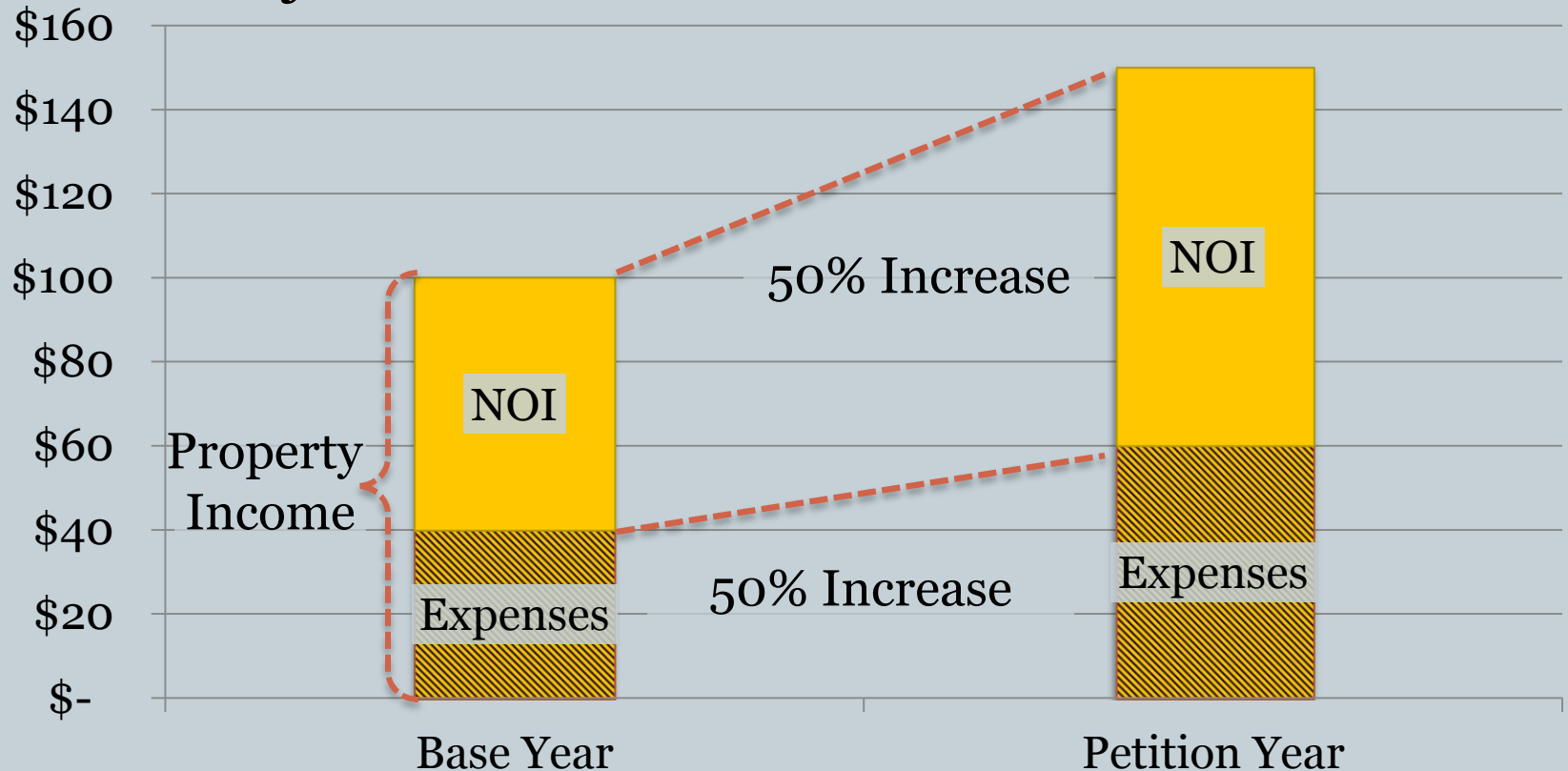
San Francisco-Oakland-San Jose, CA (1982-84=100 unless otherwise noted)

Item and Group	Indexes			Percent change from-		
	Feb. 2017	Mar. 2017	Apr. 2017	Apr. 2016	Feb. 2017	Mar. 2017
Expenditure category						
All Items	271.626	-	274.589	3.8	1.1	-
All Items (1967=100)	835.053	-	844.164	-	-	-
Food and beverages	267.322	-	269.739	1.4	0.9	-
Food	267.295	-	269.594	1.2	0.9	-
Food at home	249.301	250.945	252.377	-0.6	1.2	0.6
Food away from home	289.007	-	290.329	3.2	0.5	-
Alcoholic beverages	273.109	-	276.953	3.1	1.4	-
Housing	319.808	-	322.893	5.9	1.0	-
Shelter	364.845	365.626	367.424	6.4	0.7	0.4
Rent of primary residence ⁽¹⁾	412.606	413.119	413.736	6.2	0.3	0.1
Owners' equiv. rent of residences ⁽¹⁾⁽²⁾	394.419	395.478	396.982	6.5	0.6	0.4
Owners' equiv. rent of primary residence ⁽¹⁾⁽²⁾	394.419	395.478	396.982	6.5	0.6	0.4
Fuels and utilities	368.463	-	393.134	8.6	6.7	-
Household energy	321.319	332.391	353.423	10.9	10.0	6.3
Energy services ⁽³⁾	321.687	333.050	354.799	11.0	10.3	6.5
Electricity ⁽⁴⁾	334.735	355.832	361.663	7.5	8.0	1.6
Utility (piped) gas service ⁽⁴⁾	279.426	271.611	322.541	19.3	15.4	18.8
Household furnishings and operations	136.113	-	134.163	-2.1	-1.4	-
Apparel	117.008	-	120.421	3.9	2.9	-
Transportation	188.125	-	191.477	3.6	1.8	-
Private transportation	178.984	-	181.998	4.8	1.7	-
Motor fuel	212.552	223.591	224.219	10.8	5.5	0.3
Gasoline (all types)	211.703	222.777	223.403	10.8	5.5	0.3
Gasoline, unleaded regular ⁽⁵⁾	211.554	222.801	223.399	10.8	5.6	0.3
Gasoline, unleaded midgrade ⁽⁵⁾⁽⁶⁾	197.182	207.521	207.606	10.7	5.3	0.0
Gasoline, unleaded premium ⁽⁵⁾	202.054	211.635	212.482	10.7	5.2	0.4
Medical care	485.741	-	491.228	-	1.1	-
Recreation ⁽⁷⁾	113.213	-	113.159	-2.2	0.0	-
Education and communication ⁽⁸⁾	140.597	-	139.675	-2.0	-0.7	-
Other goods and services	440.022	-	464.566	7.0	5.6	-

3. Three Fair Return Standards

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2. Maintain Net Operating Income (MNOI) – Ratio Adjustment



3. Three Fair Return Standards

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3. Fixed Rate of Return on Investment

- Uniform Rate of Return (typically 4-12%)
- Rate of Return defines Minimum Annual NOI

Investment \times Rate of Return $=$ Minimum NOI

\$1,000,000 \times 5% $=$ \$50,000

4. Example MNOI – CPI Adjustment

	Year	CPI	Income	Expenses	Actual NOI	CPI NOI	NOI Differ.
Base	2015	100	\$100,000	\$40,000	\$60,000	N/A	N/A
Petition A	2020	+30%					

4. Example MNOI – CPI Adjustment

	Year	CPI	Income	Expenses	Actual NOI	CPI NOI	NOI Differ.
Base	2015	100	\$100,000	\$40,000	\$60,000	N/A	N/A
Petition A	2020	+30%				<u>\$78,000</u>	

4. Example MNOI – CPI Adjustment

	Year	CPI	Income	Expenses	Actual NOI	CPI NOI	NOI Differ.
Base	2015	100	\$100,000	\$40,000	\$60,000	N/A	N/A
Petition A	2020	+30%	\$130,000	\$40,000		\$78,000	

4. Example MNOI – CPI Adjustment

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	Year	CPI	Income	Expenses	Actual NOI	CPI NOI	NOI Differ.
Base	2015	100	\$100,000	\$40,000	\$60,000	N/A	N/A
Petition A	2020	+30%	\$130,000	\$40,000	<u>\$90,000</u>	\$78,000	\$12,000

4. Example MNOI – CPI Adjustment

	Year	CPI	Income	Expenses	Actual NOI	CPI NOI	NOI Differ.
Base	2015	100	\$100,000	\$40,000	\$60,000	N/A	N/A
Petition A	2020	+30%	\$130,000	\$40,000	\$90,000	\$78,000	\$12,000
Petition B	2020	+30%		<u>\$50,000</u>		\$78,000	

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	Year	CPI	Income	Expenses	Actual NOI	CPI NOI	NOI Differ.
Base	2015	100	\$100,000	\$40,000	\$60,000	N/A	N/A
Petition A	2020	+30%	\$130,000	\$40,000	\$90,000	\$78,000	\$12,000
Petition B	2020	+30%	\$130,000	\$50,000	\$80,000	\$78,000	\$2,000

4. Example MNOI – CPI Adjustment

	Year	CPI	Income	Expenses	Actual NOI	CPI NOI	NOI Differ.
Base	2015	100	\$100,000	\$40,000	\$60,000	N/A	N/A
Petition A	2020	+30%	\$130,000	\$40,000	\$90,000	\$78,000	\$12,000
Petition B	2020	+30%	\$130,000	\$50,000	\$100,000	\$78,000	\$2,000
Petition C	2020	+30%	\$130,000	<u>\$60,000</u>		\$78,000	

4. Example MNOI – CPI Adjustment

	Year	CPI	Income	Expenses	Actual NOI	CPI NOI	NOI Differ.
Base	2015	100	\$100,000	\$40,000	\$60,000	N/A	N/A
Petition A	2020	+30%	\$130,000	\$40,000	\$90,000	\$78,000	\$12,000
Petition B	2020	+30%	\$130,000	\$50,000	\$100,000	\$78,000	\$2,000
Petition C	2020	+30%	\$130,000	\$60,000	\$70,000	\$78,000	-\$8,000

4. Example MNOI – CPI Adjustment

	Year	CPI	Income	Expenses	Actual NOI	CPI NOI	NOI Differ.
Base	2015	100	\$100,000	\$40,000	\$60,000	N/A	N/A
Petition A	2020	+30%	\$130,000	\$40,000	\$90,000	\$78,000	\$12,000
Petition B	2020	+30%	\$130,000	\$50,000	\$100,000	\$78,000	\$2,000
Petition C	2020	+30%	\$130,000	\$60,000	\$70,000	\$78,000	-\$8,000

MNOI – CPI Adjustment Summary Table

4. Example MNOI – Ratio Adjustment

	Year	CPI	Income	Expenses	Actual NOI	NOI Ratio	Min. NOI
Base	2015	100	\$100,000	\$40,000	\$60,000	1.5	N/A
Petition A	2020	+40%	\$140,000				
Petition B	2020	+40%	\$140,000				

4. Example MNOI – Ratio Adjustment

	Year	CPI	Income	Expenses	Actual NOI	NOI Ratio	Min. NOI
Base	2015	100	\$100,000	\$40,000	\$60,000	1.5	N/A
Petition A	2020	+40%	\$140,000	\$50,000	\$90,000	1.5	\$75,000
Petition B	2020	+40%	\$140,000				

4. Example MNOI – Ratio Adjustment

	Year	CPI	Income	Expenses	Actual NOI	NOI Ratio	Min. NOI
Base	2015	100	\$100,000	\$40,000	\$60,000	1.5	N/A
Petition A	2020	+40%	\$140,000	\$50,000	\$90,000	1.5	\$75,000
Petition B	2020	+40%	\$140,000	\$60,000	\$80,000	1.5	\$90,000

4. Example Fixed Rate of Return Adjustment

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Rate of Return	Investment	Min. NOI	Income	Expenses	Actual NOI	NOI Differ. (Actual – Min.)
5%	\$1,000,000	\$50,000				
9%	\$1,000,000	\$90,000				

4. Example Fixed Rate of Return Adjustment

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Rate of Return	Investment	Min. NOI	Income	Expenses	Actual NOI	NOI Differ. (Actual – Min.)
5%	\$1,000,000	\$50,000	\$100,000	\$50,000	\$50,000	\$0
9%	\$1,000,000	\$90,000				

4. Example Fixed Rate of Return Adjustment

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Rate of Return	Investment	Min. NOI	Income	Expenses	Actual NOI	NOI Differ. (Actual – Min.)
5%	\$1,000,000	\$50,000	\$100,000	\$50,000	\$50,000	\$0
9%	\$1,000,000	\$90,000	\$100,000	\$50,000	\$50,000	-\$40,000

5. Question for Consideration

What Fair Return standard do other jurisdictions use?

Jurisdiction	Fair Return Standard
Berkeley	MNOI (CPI), adopted by regulation
Santa Monica	MNOI (CPI), adopted by regulation
Los Angeles	MNOI (CPI), adopted by regulation
East Palo Alto	MNOI (CPI), in ordinance
West Hollywood	MNOI (CPI), in ordinance
Beverly Hills	MNOI (CPI), in ordinance
Alameda	List of factors, no specific standard
Oakland	Hybrid MNOI (CPI, plus pass through of some cost increases over prior year)
San Jose	MNOI (CPI), proposed and under revision
San Francisco	MNOI (Ratio), adopted by regulation
Richmond	List of factors, no specific standard
Los Gatos	Increases in operating costs and debt service, no specific standard
Hayward	List of factors, no specific standard, limited pass through increases in debt service

5. Question for Consideration

Summary Explanation of Staff Recommendation

<u>Metric</u>	<u>MNOI-CPI Adjustment</u>	<u>MNOI – Ratio Adjustment</u>	<u>Fixed Return on Investment</u>
Ease of Administration	+	/	-
Fairness to Landlords & Tenants	/	/	/
Use in California	+	/	-

Note: "+" means positive attribute for given metric; "/" means neutral; "-" means negative.

5. Questions for Consideration

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Questions:

Q1: Does RHC wish to adopt regulations for a method and specific fair return standard?

Q2: If yes, **which standard** should be incorporated into draft regulations for the RHC to consider?

5. Question for Consideration

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Questions:

Q2(a): If RHC wishes to pursue an **MNOI variant or Fixed Return on Investment**:

- How would RHC prefer to identify qualifying operating expenses as compared to capital improvement costs precluded under Section 1710(a)(3)(C)? Should regulations include a list?
- How would RHC prefer to address anomalies in annual operating costs? Should regulations include a standard amortization schedule for common improvements providing benefits to tenants for more than one year even though purchased in one year?

5. Question for Consideration

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Questions:

Q2(b): If RHC wishes to pursue an

MNOI Adjustment methodology:

Would RHC prefer to allow net operating income to increase with all or a portion of any increase in the consumer price index?

5. Question for Consideration

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Questions:

Q2(c): If RHC wishes to pursue an

MNOI Ratio Adjustment methodology:

Would RHC prefer to determine one base year for all petitions or allow hearing officers to define the appropriate base year on a petition-by-petition basis?

5. Question for Consideration

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Questions:

Q2(d): If RHC wishes to pursue an

Fixed Return on Investment methodology:

- Would RHC prefer to define fixed rate of return in regulations in perpetuity, on annual basis or at some other interval?
- What info or factors would inform RHC's consideration of fair return standard?

Fair Return Standard

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