Issues and Options for Rent Increase Standards Under Berkeley's Rent Stabilization Ordinance

Kenneth K. Baar
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This was report was commissioned by the Rent Board for the purpose of providing technical assistance in its review of the current rent regulations. The views stated herein are those of the author and do not necessarily represent the views of the Board.

In addition to preparing this report, this author submitted separate written responses to public comments, which were submitted at the October 16 Rent Board meeting.

The author gratefully acknowledges the assistance provided by the Rent Board staff and by Melanie Simmons, who served as a research assistant on this project.

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The Author

A copy of the author's resume is attached as Appendix C.

The author has a Ph.D in urban planning and is an attorney. He has researched and published extensively on housing policy issues. Last year, he was a visiting professor in the Urban Planning graduate program at Columbia University.

Over the past 15 years, he has served as a consultant to numerous California jurisdictions and New Jersey jurisdictions on rent control issues. His articles on rent control have been extensively cited by appellate courts, especially in regards to fair return issues.

I. Introduction -

A. Scope of report

This report was prepared in response to a request by the Rent Board for a policy and legal analysis of its options in regard to:

1. The annual general adjustment (across-the-board increase) standard,

2. The fair return standard,

3. Standards for rent individual rent adjustments based on:
   (a) capital improvements,
   (b) historically low rents,
   (c) property tax increases triggered by sales,

B. Background

1. The Annual General Adjustment and Fair Return Standards

Berkeley's rent control ordinance[1] authorizes the Rent Board to set annual general adjustment standards and to formulate fair return standards for individual rent adjustments.

Section 11 of the ordinance which governs across-the-board rent ceiling adjustments directs the Board to consider increases and decreases in apartment operating expenses when setting the allowable annual increase. It states that:

> Once each year, the Board shall consider setting and adjusting the rent ceiling for all rental units covered by this Ordinance ...
>
> In adjusting rent ceilings under this subsection, the Board shall adopt a formula or formulas of general application, ... based upon ... data indicating increases or decreases in the expenses relating to the rental housing market in the City of Berkeley...[2]

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[1] Berkeley Municipal Code (B.M.C.) Sections 13.76.010 - 13.76.190.

[2] B.M.C. 13.76.110.

Section 12 governing individual rent adjustments, based on fair return and other criteria, gives the Board authority to provide for increases which meet constitutional requirements and accomplish other policy objectives. It directs the Board to "consider all relevant factors, including (but not limited to) ... increases or decreases in property taxes; ... maintenance and operating expenses; ... the cost of ... capital improvements .. increases or decreases in the number of tenants, ... the pattern of recent rent increases... the landlord's rate of return on investment."[3] Furthermore, it states that the ordinance shall not be applied "to prohibit the Board from granting an individual rent adjustment that is demonstrated necessary ... to provide the landlord with a fair return on investment."[4]

In setting both across-the-board increases and in making individual rent adjustment determinations, the Board has used a maintenance of net operating income (MNOI) concept. Understanding of this concept is central to understanding both the operation of the Rent Board's regulations and the policy and legal issues that have emerged over the years.

In applying the MNOI concept, rental income is divided into two portions - operating expenses and net operating income (NOI). Net operating income is the income that a property yields net of operating expenses. Typically NOI is equal to 40 to 60% of gross rental income. It is the portion of the rental income that may cover debt service and provide cash flow to the owner. Debt service and related financing expenses are not considered operating expenses. Rent increases are calculated by determining the amount of increase necessary to cover operating expense increases and to permit a specified increase in net operating income.

In order to calculate annual general adjustments, the Board commissions annual studies of increases in apartment operating expenses and the amount of rent increase required to cover each of these expense increases. Essentially a weighted cost index is used. In addition, a calculation is made of the rent increase necessary to permit a specified increase in the NOI portion of gross income. The table on the following page contains a simplified version of a hypothetical calculation.[5]

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[3] B.M.C.Sec. 13.76.120.C.

[4] B.M.C. Section 13.76.120.I.

[5] The increase in each cost is weighted according to its ratio to gross apartment income. For example, if water expenses equal 2% of gross income and they increase by 15%, a 0.30% (2% x 15%) rent increase is needed to cover this cost increase. The total increase required to cover operating cost increases is computed by adding the required rent increase for each of the individual expenses.

Maintenance of Net Operating Income
Rent Calculation

	Base Level Pct. of Rent	Pct.Inc.	Pct. Rent Increase Required to Cover Increase
Water	2%	15%	0.30%
Refuse Collection	3%	5%	0.15%
Sewer Service	3%	0%	0.00%
Insurance	2%	8%	0.16%
Maintenance	7%	4%	0.28%
Management	6%	5%	0.30%
Property Taxes	6%	2%	0.12%
Other Oper. Expenses	11%	6%	0.66%
Net Operating Income	60%	4%	2.40%
Rent	100		4.36%

Individual rent adjustments in order to maintain net operating income are calculated by considering the expenses and income of the individual property.[6] They permit greater rent increases for apartment owners who have had above average increases in operating expenses.

Within the foregoing framework, a number of policy and legal issues have emerged. They have principally centered on the amount of increase in NOI that should be permitted and what is necessary to comply with constitutional fair return requirements.

In the first part of the 1980's, the Board's annual general adjustment and fair return policies were designed to permit rent increases which covered operating cost increases, but did not provide for any growth in NOI.

In 1984, in Fisher v. City of Berkeley, the California Supreme Court declared that "although defendants' ordinance may properly *restrict* landlords' profits on their rental investments, it may not indefinitely *freeze* the dollar amounts of those profits without eventually causing confiscatory results."[7] However, the Court did not elaborate on this concept by specifically defining the terms "profit" or "indefinitely freeze", nor did it indicate specifically what rate of growth in "profits" had to be permitted. But the opinion clearly established that it was not sufficient to provide for rent increases which only covered operating cost increases, without permitting growth in net operating income.

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[6] Rent Board Regulations 1264 & 1265.

[7] 37 Cal.3d.644,683; 209 Cal.R.682,713 (1984).

In response to the Court opinion, the Rent Board amended the individual rent adjustment standard to define fair return as base period net operating income "indexed" by 40% of the increase in the Consumer Price Index (CPI) since 1980.[8] But, the across-the-board (annual general adjustment) standard was not modified. Therefore, an owner had to go through the individual rent adjustment process to obtain growth in net operating income.

In 1990, in Searle v. Rent Stabilization Board,[9] the Court of Appeal ruled that it was not reasonable to require that apartment owners go through the individual rent adjustment petition process in order to obtain growth in net operating income. Therefore, the Board was required to modify the annual general adjustment standard to permit growth in net operating income. Also, the Court ruled that the Board's decision to index net operating income at 40% of the rate of increase in the CPI did not have a rational basis. The Court declared the data that relied on by the Board in setting the indexing ratio "arguably justify a figure of 50 percent or more, but do not constitute a rational basis for the choice of 40 percent indexing."[10]

In 1991, the Rent Board adopted regulations which defined fair return as base period net operating income indexed by 100% of the increase in an alternate price index (the Consumer Price Index - all items less shelter)[11] between 1979 and 1990. Pursuant to this policy, it granted an across-the-board increase of 28%[12] (the "Searle" increase) for the purpose of increasing the net operating income of rental units by 75% over their 1979 levels.[13] Subsequent annual across-the-board increases have been designed to cover operating cost increases and permit net operating income to increase at 100% of the rate of increase in the CPI all items less shelter.

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[8] E.g. for each 10% increase in the CPI a 4% increase in NOI was permitted.

[9] 222 Cal.App.3d.131 (1990, depublished Oct.25,1990).

[10] Id., 222 Cal.App.3d. at 138.

[11] Like the CPI all items, this index is published by the Bureau of Labor Statistics.

[12] Regulation 1113 authorized rent adjustments equal to 45% of May 31, 1980 rents. This increase was equal to approximately 28% of current rents.

[13] See "Legal Staff's Recommendation on Appeal in L-2198, Exhibit A" (August 31, 1994) for tables demonstrating how the increase was calculated.

Since rent regulations were instituted in November 1978,[14] across-the-board rent adjustments through January 1995 have totalled 130% compared with a 128.5% increase in the CPI for the period from June 1978 through June 1994.[15]

2. Individual Rent Adjustment Standards

In addition to authorizing individual rent adjustments in order to maintain NOI, the Board's regulations authorize individual rent adjustments for:

- "capital improvement" expenditures (defined as work with a useful life of one year or more costing in excess of $200 per unit, including painting and replacements)[16]

- historically low rents, defined as base date (1980) rents below 75% of Department of Housing and Urban Development fair rents.[17]

- increases in property taxes triggered by the sale of a property.[18]

From 1987 through June 1995, 14,595 individual rent adjustments were obtained. In a substantial portion of the individual adjustment cases, increases were granted on more than one ground. The average increase was $49.34. Here the total of 14,595 refers to the number of increases rather than to the number of units granted increases, and the average increase refers to each "type" of increase rather than the total amount each unit obtained. Approximately half of the increases were for capital improvements and have been limited in term to the life of the improvement; while the other half are permanent adjustments to the base rent. Taking only the

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[14] The current ordinance was adopted in 1980. However, in 1979 apartment owners were required to passthrough to tenants 80% of the property tax reduction resulting from Proposition 13. (Measure I). Those reductions averaged approximately seven percent of gross income. See note 21 infra. estimate is derived.

[15] San Francisco-Oakland CPI all items all urban consumers - June 1978 - 64.8, June 1994 - 148.1. Since 1981, annual rent increases have been designed to cover cost increases between from June to June of the preceding years. The November 1978 ordinance rolled back rents to June 6, 1978 levels.

[16] Rent Board Regulation 1267.

[17] Rent Board Regulation 1280.

[18] Rent Board Regulation 1279.

permanent increases into account raises the overall average allowable rent increase to approximately 138%,[19] compared to the CPI increase of 128.5%.

3. State Vacancy Decontrol Legislation

In July 1995, the state legislature adopted a statute (the Costa-Hawkins Rental Housing Act[20]), which preempts local rent control laws and institutes vacancy decontrol (unlimited increases upon vacancies) starting in 1999. Until 1999, rents may be increased upon vacancy by 15% or up to 70% of "prevailing market rent" (as defined by HUD), whichever is greater. No more than two vacancy increases are permitted during this period. Single family dwellings and condominiums become exempt from all rent control upon vacancy. Starting in 1999, all single family dwellings and condominiums become exempt from rent controls, except in cases where the unit has been occupied by the same tenant since Dec. 31, 1995.

Discussion of issues related to the Rent Board's regulations is preceded by a presentation of data that was collected in the course of this study and other background information.

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[19] The data base on increases before 1987 is incomplete. However, it is known that at least 500 increases were granted before that time, raising the total number of individual rent adjustments to over 15,000. If the 7,500 permanent increases were divided equally among all the 19,759 units covered by rent control the average permanent increase would be $18.70. ($49.34 x 7500 : 19,759). Adding these increases to the across-the-board increases would raise the overall rent increases approximately another 8% over their base levels of approximately $240. The precise impact of the increases on the overall increase amount would depend on how much they have been compounded by subsequent rent increases, which in turn would be determined by how long they have been added to the base rent. Alternate estimates of the base rent would not significantly change the percentage increases over base levels attributable to the individual rent adjustments.

Taking into account the the capital improvement increases which are still in effect would raise would raise the overall average rent increases by a few additional percentage points.

[20] California Civil Code Sec. 1954.2 (_____ 1995, _____)

II. Market Developments and Related Background Information

The purpose of this section is to provide background information on the operation of Berkeley's rental housing and investment market. Such information is useful in considering potential impacts of the Rent Board's policy alternatives and of the new state legislation. While very detailed discussion of the overall housing market and the rental housing market is beyond the scope of this report,[21] it is critical to understand the significant interplay between developments in the overall housing market and the rental housing market (i.e. increased demand for owner-occupied housing increases pressure for the conversion of rental units to owner occupancy).

This section presents data, which was collected in the course of this study, on:

- turnover in ownership of rental units since the adoption of rent control
- trends in market values of rent controlled units
- financing arrangements associated with investments in rent controlled units
- asking rents for vacant units compared to legal rent ceilings

In addition, it contains background data on:

- median rents for Berkeley units compared with Bay Area medians
- the size of the rent controlled stock
- median rent levels of controlled units
- conversions of units from owner occupancy to rental

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[21] For additional background information see Community Development Department, "Rent Control in the City of Berkeley, 1978 to 1993: A Background Report for Updating the City of Berkeley's General Plan Housing Element (draft)" (1993).

A. The Size and Characteristics of the Rent Controlled Stock

Presently, 19,052 units are registered with the Rent Control Board. The following chart provides the distribution of units by building size. (For statistical purposes, the data in this table and the balance of the report is based on all 19,759 units which have been registered at any time.

Rent Controlled Units
Size of Building[22]

Size of Building (no. of units)	No. of Units
1 - 4	5,912
5 - 10	5,227
11 - 15	1,948
16 - 20	1,640
21 - 25	1,294
26+	3,738
Total	19,759

1,104 of the rent controlled units are single family dwellings. Pursuant to the Costa-Hawkins Rental Housing Act, these units become exempt from rent control upon vacancy or in 1999, whichever occurs first, except when the unit has been occupied by the same tenant since Dec. 31, 1995.[23] In addition, several hundred apartments which have been converted to condominiums will become exempt.[24]

B. Rent Ceilings of Rent Controlled Units

The current median legal rent ceiling of Berkeley's rent controlled units is $587. (The average legal rent ceiling is $674.) Current actual rent levels are not known. (For discussion of the relationship of legal rent levels and actual rents see text at notes 36-37, infra.) There is no question that some units have legal rent levels which are above the rents charged and that some

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[22] Source: Computer Printout supplied by Rent Board Staff, July 1995

[23] California Civil Code Sec. 1954.2, ___ (_____ 1995, _____)

[24] Condominium conversions are strictly regulated, see discussion at notes 39-44, infra.

units have legal rent levels above market levels.[25] However, there is disagreement over whether few or many units fall into these categories.

Most of the stock consists of one and two bedroom units. 48% of the units have one bedroom and 33% have two bedrooms.

MEDIAN RENT CEILINGS OF RENT CONTROLLED UNITS[26]
(June 1995)

No. of Bedrooms	Median Rent
0	$459
1	549
2	678
3	904
4	1225
5	1515

The 1990 Census contains median rent data for neighboring cities. 1990 median rents for neighboring cities were as follows: Albany - $608; El Cerrito - $645; Emeryville - $676; Oakland - $486.[27] Since the census, the rent index for the San Francisco S.M.S.A. has increased by 14%.[28] In viewing this data and considering its significance, it should be understood that the age of the rental stock and the average number of bedrooms varies substantially among the cities. Berkeley's rental stock is older (which may make it more or less desirable) and has a lower number of bedrooms on the average.[29]

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[25] In some cases, legal rents may be above the rents charged but still not be above market rents because the owner elects to charge less than market rent.

[26] These medians are based on data for 16,063 units in the Board's data base. Data on the balance of the units (3,697) did not include bedroom information.

[27] Source: Median Contract rent data supplied by ABAG.

[28] In June 1995 the index was at 170.0; in March 1990 it was 148.8.

[29] The percentages of rental units that had two or more bedrooms were as follows: Berkeley - 41.9%, Albany - 61.4%; El Cerrito - 73.2%; Emeryville - 36.3%; Oakland - 44.4%. The percentages of rental units that were constructed in 1939 or earlier were as follows: Berkeley - 45.1%, Albany - 21.8%; El Cerrito - 9.3%; Emeryville - 22.6%; Oakland - 30.0%. Source, Census data from Summary Tape File 3A (ABAG Regional Data Center) page 14 of data for each city ("Housing Size and Age").

C. Turnover in Ownership of Rent Controlled Units[30]

Approximately 58% of the units under rent control have been sold since the rent regulations went into effect in 1978. The acquisition dates of current owners are as follows: 42% of the units were purchased between 1985 and June 1995. 19% were acquired after the Searle decision.[31]

ACQUISITION DATES OF RENT CONTROLLED UNITS

Purchase Date	Pct. of Units
1959 or earlier	7%
1960 - 1969	11
1970 - 1974	7
1975 - 1979	20
1980 - 1984	12
1985 - 1989	18
1990 - 1995 (June)	24

Length of ownership patterns do not differ substantially for units in larger buildings.

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[30] The data in this section is based on a review of ownership information contained in the Rent Board registration files of a random sample of rent controlled units. The original sample contained 975 units. However, 190 cases were excluded because the information in the file was not clear or complete. The final sample size was 785 cases.

The distribution of units by size of property closely tracked the overall distribution of rent controlled units.

[31] The Searle decision became final in November 1990. The above ratio covers units purchased after December 1990.

D. Trends in Apartment Values[32]

Berkeley apartment values more than doubled in the 1970's. In the 1980's, they remained at about the same level. From the mid-1980's to 1995 they have increased by 50% on the average.

Average Apartment Values
(1973-81, 4 or more unit bldgs.)
(1982-95, 5 or more unit bldgs.)

Years	Average Price Per Unit
1973 - 1975	$12,000
1976	$13,392
1977	$17,312
1978	$20,000
1979 - 1981	$30,000
1982 - 1986	$30,000
1987 - 1989	$34,224
1990 - 1991	$40,666
1992 - 1995	$45,000

The increase in values between the mid-1980's and 1995 of approximately 50% is not as great as the increases in NOI of about 100%, during the same period.[33] This difference may be explained by the fact that prices were higher relative to NOI in 1980 (alternatively stated, the capitalization rate was lower). These differences in capitalization rates typically reflect differences in expectations about appreciation, as investors will pay higher prices relative to current NOI if they expect greater appreciation.

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[32] The averages for 1982 through 1995 have been estimated by this author based on sales information contained in the publications of the Board of Realtors Multiple Listing Service (MLS) and the TRW REDI Property Data service. The MLS contained information on approximately 200 sales between 1982 and 1995. The TRW service reports contained information on 302 apartment sales between 1987 and 1995.

The estimates for the periods prior to 1982 were set forth in Baar, Francis, Gellen, and Keating, "Berkeley Rent Stabilized Properties Operating Costs and Debt Service" (Sept. 1982, Berkeley Rent Stabilization Board, annual operating cost study.)

[33] The Searle increase was designed to increase the 1979 NOI by 75%. Income and expense data from a 1994 report for the Rent Board indicates that the NOI levels were as follows: 1981 - $136.15; 1985 - $146.52; 1993 - $291.33. Elder, "Historical Review of Changes in the Operating Expenses for Rent Stabilized Units in the City of Berkeley", Table VII-1) (July 8,1994, Fourth Draft Report). (The table relied on does not actually contain NOI figures. Instead, these figures were calculated by this author by subtracting the operating cost figures from median rent figures in Elder's tables.)

The 100% increase in apartment values between 1975 and 1980 was guided by expectations about future rental income, rather than the 50% rent increases that occurred during that period. These increases in Berkeley apartment values occurred at a time of exceptional increases in values in the overall real estate market.

E. Financing of Apartment Investments[34]

For the period 1987 through 1995, loan to value ratios on first mortgages associated with apartment purchases have generally been in the 60 to 80% range. Data was compiled on the financing associated with the purchase of 250 buildings with 5 or more unit (which contained a total of 3210 units.) It indicated that in 59% of the cases, the purchasers obtained first loans for between 60 and 80% of value.[35] In another 9% of the cases financing of 80% or more was obtained. This financing was obtained from banks and savings and loans associations.

Loan to value ratios did not differ significantly between the periods before and after the Searle increase, nor did they differ substantially for larger buildings.

21% of the purchases involved second mortgages, which were usually provided by the seller. These accounted for seven percent of all of the financing obtained.

F. "Market Rents" Compared with Legal Rent Ceilings

It is widely believed that a substantial proportion of all units now have legal rent control rent levels which at are at or above market levels. This view was repeated by key informants from the University of California housing office and the realtors community. As a part of this study, asking rents for a substantial sample of listings in 1993 and 1994 from the U.C. housing office were compared with legal rent levels.[36] Of the 523 listings reviewed, 23% had asking rents

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[34] Financing data is included in the TRW reports, supra note 32.

[35] 52 cases in which the purchaser did not obtain a new first mortgage are excluded from this sample. The reports did not indicate what portion of these cases involve assumptions of existing loans or all cash purchases.

[36] The housing office has thousands of listings. The comparison contained herein was limited to the listings which contained unit identification (apartment number etc.) as well as the street address. Most of the listings just contained the street address and the telephone number of the owner or manager. However, the remaining sample was still more than adequate to be a statistically reliable sample of the listings of the U.C. housing office.

which were $100 or more below legal rent levels.[37] Asking rent to legal rent ratios are summarized in the table below:

Asking Rent to Legal Rent Ratios
U.C. Housing Office Sample

Asking Rent to Legal Rent Ratio	Pct. of Units
98% or greater	48%
90 - 97%	22%
80 - 89%	17%
under 80%	13%

G. Turnover in Tenants

To the extent that owners will be able to obtain rent increases when apartments become vacant, the rate of turnover in tenants is particularly significant. 1990 Census data[38] indicates that 31% of all Berkeley tenants moved into their units within the prior 15 month period. Another 35% moved between 15 and 63 months before they were surveyed. 16% had been in their units ten years or more.

Varying theories can be used to support alternate predictions about changes in turnover rates that will result from the introduction of vacancy decontrols. Discussion of these issues is beyond the scope of this report, except to note that moves are largely determined by changes in life circumstances (new job, change in family size, etc.) and that intuitively based conclusions and predictions about turnover trends often do not conform with reality.

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[37] The President of the Berkeley Property Owner's Association commented that the listings of the U.C. housing office are "hardly representative of units throughout Berkeley." (Vicars to Pincetich letter, Oct.4,1995, p.2). The letter sets forth a variety of reasons for this conclusion, including that low rent units are less likely to be listed with the housing office because they are easier to rent and that the U.C. listing are the "cream of the crop". Further research on the sample would be required to confirm or rebut these views. The U.C. sample was used because it was largest known available sample. The most reliable approach to determining the relationship between legal rent ceilings and actual rents would be a survey of a random sample of tenants.

[38] 1990 Census of Housing, Detailed Housing Characteristics, California (Section 1 of 2), p. 511 (Table 80, "Fuel, Occupancy, and Social Characteristics: 1990")

(For other data on recent movers (for the whole metropolitan area, but not by city), including changes in housing costs associated with the move, see U.S. Census, Annual Housing Survey, 1992, Table 2-10 "Previous Unit of Recent Movers")

H. Conversions of Units from Rental to Owner Occupancy

The issue of conversions from rental to owner occupancy has been the subject of much discussion and debate during the past decade.[39] The primary type of conversions in the 1980's were changes in the use of single family dwellings, from rental to owner occupancy status. Between the 1980 and 1990 census, the number of single family dwellings that were rented declined from 4,900 to 3,613.[40]

In the 1980's, when condominium conversions were virtually prohibited in Berkeley, some units, primarily in smaller buildings, were converted from rental to owner occupancy through the creation of tenancy in common (TIC) ownership. Under this form of ownership, all of the units are commonly owned, but occupancy rights to individual units are divided up through contractual arrangements. TIC ownership suffers from the drawback that all of the owners share in the same mortgage financing. A precise count of the number of TIC conversions is unavailable. One estimate of the City Planning staff is in the range of 700 units.[41] In 1992, the city banned the formation of new TIC interests, except in buildings with two or three dwelling units.[42]

In 1993, the City also amended its laws to permit the conversion of existing TIC interests to condominiums.[43] In addition, up to 100 rental units may be converted year each subject to consent by the majority of the tenants in the building and the payment of an "Affordable Housing Fee".[44]

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[39] Supra note 21, Ch. VII, pp.79-105.

[40] Id., p.92.

The number of rented single family dwellings reported by the Census Bureau differs substantially from the number of single family dwellings registered with the Rent Board. See text at note 22, supra.

[41] Id. note 21 at 99.

[42] Berkeley Municipal Code, Sec. 21.28.040.

[43] Berkeley Municipal Code, Sec. 21.28.040.

[44] Berkeley Municipal Code Sections 21.28.040 & .050.

III. The Overall Rate of Rent Increases and Net Operating Income Indexing Standards

The purpose of this section is to discuss issues and options in regards to Berkeley's annual general adjustment and individual rent adjustment standards from a legal, policy, and comparative perspective.

From a policy and historical perspective there is no generally accepted rule as to what rent increases would produce the most reasonable results.

Also, from a legal perspective, there is no precise judicial standard as to what rent increases and/or what rate of indexing of net operating income are constitutionally required to be permitted under rent regulation. Furthermore, the California Supreme Court has consistently ruled that no particular type of fair return formula is required.[45] The governing judicial doctrine has been that: (1) the determination of "whether rental regulations are fair or confiscatory depends ultimately on the result reached"; (2) that determination "can only be made by analyzing a challenge to the regulation as applied"; (3) however, a regulation will be declared "invalid on its face 'when its terms will not permit those who administer it to avoid confiscatory results in its application to the complaining parties.'[cites omitted]"[46]

In considering judicial precedent, it is important not to take particular statements out of context and to understand that varying conclusions can be drawn from the decisions of the past two decades. In addition, it is critical to realize that judicial doctrine in this area is in a state of evolution. Therefore, precedent is not a certain guide as to how the courts may rule in future cases.

The following sections consider Berkeley's rent increase regulations and alternative indexing ratios from various perspectives of reasonability. The first section compares the increases in rents permitted under Berkeley's rent regulations with increases in the Consumer Price Index (CPI). The second section compares rent increases permitted in Berkeley with national rent increase patterns. The third section describes across-the-board increase standards under other rent control ordinances in California. The fourth section discusses considerations in the selection of an indexing ratio under MNOI standards.

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[45] "As we recently stressed in Carson, '[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.' [cites omitted] Fisher v. City of Berkeley, 37 Cal.3d.644,680; 209 Cal.Rptr.682,711 (1984).

[46] Id.

A. Increases in Rent Ceilings and the CPI

1. Increases in Rent Ceilings under the Berkeley Law Compared with Increases in the CPI (for the San Francisco area)

Traditionally the reasonability of rent increases has been measured by a comparison with increases in the CPI. The concept has been that rents should be able to keep up with inflation. Longterm commercial leases have commonly provided for annual adjustments tied to this index. Rent ordinances commonly tie annual increases to all or a portion of the percentage increase in the CPI, in contrast with Berkeley's ordinance which ties rent increases to changes in apartment operating costs.[47]

In Berkeley, in 1979, pursuant to Measure I, Berkeley apartment owners were required to roll back rents to June 1978 levels and, in addition, were required to pass through 80% of their Proposition 13 tax reductions to tenants.[48] As a result, legal rent levels were reduced by about 7% on the average.[49] In 1980, rent increases were limited to increases in operating costs, subject to a 5% ceiling on increases.[50] During these two years, there was a real reduction in legal rent levels relative to the CPI; they were not permitted to increase during a period in which the CPI increased by 27.9%.[51]

Since adoption of the "permanent" rent control ordinance, across-the-board rent increases from 1981 through 1995 have raised rent ceilings by 136%. Taking into account permanent individual rent adjustments raises the overall rate of increases in rent ceilings to approximately 144%.[52] These compare with an increase of 114% in the CPI for the June 1979 to June 1994 period that was considered in setting the 1981 through 1995 across-the-board increases.

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[47] For discussion of alternate methodologies for setting annual rent adjustments see Baar, "Guidelines for Drafting Rent Control Laws: Lessons of a Decade", 35 Rutgers Law Review 721, 768-775 (1983).

[48] Ordinance No. 5109-N.S. (1978).

[49] Supra note 21 at 33-34.

[50] Ordinance No. 5212 N.S., Section 7 (November 1979).

[51] CPI all items (San Francisco-Oakland-San Jose) June 1978 - 64.8, Dec. 1980 - 82.9.

[52] See note 19, infra. In addition to the permanent individual rent adjustments, approximately 7,500 capital improvements increases have been granted, which have usually have either a five or ten year amortization period.

During ten years of "stricter" rent increase regulations under the current law, (1981 - 1990), rent increases were equal 53%,[53] compared to an 83% increase in the CPI during the June 1979 through June 89 period that was considered in setting the across-the-board increases. Primarily as a result of the Searle increase, from 1991 through 1995, across-the-board increases were 54% compared to a 17% increase in the CPI for the corresponding June 89 through June 1994 period.[54] Without the Searle increase, the rent increases for this period still would have exceeded the increase in the CPI by approximately 3%.

If the Measure I rent reduction is taken into consideration and it is assumed that allowable rent increases for 1979 and 1980 were limited to a total of 5%,[55] the annual across-the-board rent adjustments for the period 1979 through 1995 have raised rent ceilings by 130%. Taking into account the permanent individual rent adjustments raises the overall rate of increase to 138%. These allowable increases compare with a 128.5% increase in the CPI from the rollback date of June 1978 through June 1994.[56] However, use of the CPI as a reasonable measure of rent increases in 1978 and 1979 would completely undermine the concepts and rationale behind

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[53] Gas and electricity expenses are paid by tenants in most apartments. Small additional rent adjustments were allowed for master-metered units in some years.

[54] San Francisco CPI, June 1989 = 126.2; June 1994 = 148.1.

[55] Measure I required varying reductions in rents, since they were tied to the particular property tax reductions of each property. Also, allowable increases in 1980 were tied to the actual expense increases for each property, subject to a 5% ceiling. The ordinances were self-enforcing. The analysis of the City Planning staff Department's analysconcluded that there were substantial increases in rents, notwithstanding the regulations. CDD Report (draft), Supra note 21 at 34-36.

[56] A substantial portion of the CPI increase took place before 1983. In 4 out 5 those years annual rates of increase exceeded 10% (See table on page __). It is commonly believed that the CPI increases for those years as measured by the Bureau of Labor Statistics exceeded actual increases in the cost of living.

During those years, there were exceptionally rapid increases in house prices. In 1983, the Bureau of Labor Statistics revised its methodology for computing the CPI on the basis that changes in house prices were overweighted. For discussion of this change see Lane and Cunningham, "Changing the treatment of shelter costs for homeowners in the CPI", __ Monthly Labor Review 9 (June 1982, Bureau of Labor Statistics).

The prior consultants to the Board recommended the use of the all-items less shelter index in order to compute reasonable growth in net operating income since 1979, "... because the unadjusted CPI-U index overstated changes in the cost of owner-occupied housing caused by rapid price increases in that market. As a consequence, general price inflation was also overstated by the CPI-U. [footnote]... This bias is accentuated during periods of rapid appreciated of home values such as the late 1970's, and even more accentuated in areas like California where this appreciation was most pronounced." Hamilton, Rabinovitz, & Alschuler, Inc., "Inflation Indexing in Berkeley Rent Regulation in the Aftermath of the Searle decision.", p. 33 (August 19, 1991).

Since 1983, increases in the CPI-all items and the CPI-all items less shelter have been about the same.

Measure I,[57] which was that rents should be reduced to reflect property tax decreases, rather than being adjusted in accord with the increase in the CPI.

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[57] Measure I was upheld by the Court of Appeal in Rue-Ell Enterprises, Inc. v. City of Berkeley, 147 Cal.App.3d.91; 194 Cal.Rptr.919 (1983).

If the CPI increase of 128.5% for this period were considered, but was adjusted downward by a 7% decrease to reflect the property tax reduction, the overall increase for this period would 113%. (This figure is calculated by compounding the decrease, consistent with the compounding of all increases.)

BERKELEY ACROSS-THE-BOARD RENT INCREASES COMPARED WITH INCREASES IN THE CPI[58]

Year	Annual General Adjustment		CPI Increase
1979	-7.20%		10.20%
1980	5.00%		6.64%
1981	5.00%		16.79%
1982	9.00%		10.41%
1983	4.75%		11.22%
1984	0%		-0.50%
1985	2.00%		5.17%
1986	3.83%		4.53%
1987	3.50%		3.23%
1988	7.91%	($25)	2.77%
1989	3.00%		4.43%
1990	4.65%	($16)	5.08%
1991	28.36%	(Searle Increase)	
1991	4.70%	($17)	4.28%
1992	5.30%	($26)	4.56%
1993	3.94%	($20)	3.12%
1994	3.43%	($18)	2.96%
1995	1.50%		1.37%

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[58] Explanation of table:

-In 1979, landlords were required to reduce their rents by an amount equal to 80% of their reduction in property taxes which resulted from Proposition 13. The average reduction was equal to 7.2% of the rent.

-1980, landlords were permitted to raise their rents by the amount of their operating cost increases, subject to a 5% ceiling.

-In order to calculate the percentage annual increases in years in which the increase was set at a dollar amount, rather than a percentage, the percentage amount is calculated by computing the dollar amount as a percentage of the median rent.

-In 1986, the across-the-board increase was 3% plus $2.50.

-In some years, small additional adjustments were allowed for master-metered units.

-CPI index used: all items, all urban consumers, S.F.-Oakland-San Jose area.

-annual increases in the CPI are computed from June to June of the two prior years, consistent with the annual general adjustment methodology which considers increases between these time periods.

-1981 through 1995 annual general adjustments took effect on Jan. 1 of each year.

2. Rent Increases in the U.S. and the S.F. Area Compared with Increases in the CPI

The Rent Index portion of the Consumer Price Index has been published by the Bureau of Labor Statistics since 1913. That data indicates that from 1913 through 1994, rents increased by approximately three-quarters of the rate of increase in the CPI on the average.

From 1960 to 1978, an eighteen year period immediately preceding the spread of rent controls to California, U.S. rents increased by approximately two-thirds the amount by which the CPI increased.[59] Since 1978, the year in which rent regulations were adopted in Berkeley, U.S. rents have increased by 96% of the rate of increase in the CPI.[60]

In considering overall historic trends in rents and the CPI, it should be noted that there have been drastic variations in the relationships between increases in rents and increases in the CPI. During some periods rents increased at only a quarter of the rate of increase in the CPI. At other times, rents increased at a much greater rate. In some periods rents increased while the CPI decreased and vice versa.

Increases in U.S. Rents and the CPI Compared[61]

Year	CPI all-items	% Inc. over prior date	Rent Index	% Inc over prior date
1913	9.9		21.0	
1920	20.0	102.0%	27.4	30.8%
1930	16.7	-16.6%	31.2	13.9%
1940	14.0	-16.0%	23.7	-24.0%
1950	24.1	71.7%	29.7	25.3%
1960	29.6	23.0%	38.7	30.3%
1970	38.8	31.1%	46.5	20.2%
1980	82.4	112.3%	80.9	74.0%
1990	130.7	58.6%	138.4	71.0%
1994	148.2	13.4%	154.0	11.2%

[59] From 1960 to 1978, the CPI all-items increased by 120%, (from 29.6 to 65.2), the rent index increased by 79.1% (from 38.7 to 69.3). Annual average CPI figures are used.

[60] Rent index: 1978 - 69.3; 1994 - 154.0; All-items index: 1978 - 65.2; 1994 - 148.2.

[61] CPI and Rent Index data are annual averages.

B. Rent Increases Permitted Under Berkeley's Rent Regulations Compared with Rent Increases in Other Areas

In this section, increases allowed under Berkeley's rent control ordinance are compared with increases in rents in different regions as measured by the rent index portion of the Consumer Price Index as compiled by the Bureau of Labor Statistics.[62]

For the period 1981-1995 the rate of rent increases permitted under Berkeley's annual general adjustments substantially exceeded the national and San Francisco Standard Metropolitan Statistical Area (SMSA) rate of increases -- a 136% increase in Berkeley versus a national increase of 84% and a San Francisco SMSA increase of 107% for the same period.[63] The increases in all of the 27 SMSA's in the nation for which the Bureau of Labor Statistics compiles a rent index were lower than the rate in Berkeley.

For the period 1979-1995 the permitted increases in Berkeley were 130% compared to a national average rate of increase in rents of 117%. However, they were below the San Francisco SMSA increase of 162% and the increases in six of the 27 SMSA's.

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[62] In response to the preliminary version of this report, representatives of the Berkeley Property Owner's Association have argued that this comparison is not appropriate and that rent increases allowed under the rent ordinance should be compared with overall increases in average rents reported in the census reports. (See letter from Vicars, President B.P.O.A. to Director, Rent Stabilization Program, Oct.4,1995, pp.2-3).

There is a compelling reason why the comparison with the CPI rent index is more appropriate. The CPI rent index is based on rents for existing units. Therefore, it is comparable in "coverage" to the Berkeley rent ordinance, which only covers pre-existing units and exempts new construction from its coverage. In contrast, the census reports take into account rents for newly constructed units in measuring median rents.

[63] The report of the formerconsultants to the Board, states that the rent component of the San Francisco regional SMSA is "probably" depressed by the fact that "... a substantial proportion of the rent component of the regional CPI-U is controlled or stabilized, thereby probably depressing the overall averages. To the extent this is true, even indexing Berkeley NOI to the relation between the rent component of the CPI-U and the overall index probably understates the relation between unregulated rents in the region and the behavior of general price levels." Hamilton, Rabinovitz, Alschuler, "Inflation Indexing in Berkeley - Rent Regulation in the Aftermath of the Searle Decision" (August 19, 1991)p. 49,n.2). Hereinafter referred to as "H.R.& A. Report".

However, in a subsequent report, regarding the Los Angeles rent index, H.R.& A. state that the existence of vacancy decontrols "probably offset much of the potential bias" caused by rent control and that the impacts of rent control were also "diluted" by the fact that the rent controlled share of the stock was only 28%. Hamilton, Rabinovitz, & Alschuler, Rental Housing Study 1994 (Los Angeles Housing Department, Rent Stabilization Division), p.69.) Substantially the same would have been true in San Francisco region when H.R.& A. prepared its report for the Berkeley Board, since San Francisco, San Jose, and Oakland have vacancy decontrol. The percentage of rent controlled units in S.F. region may be 5 to 10% higher.

RENT INCREASES PERMITTED UNDER BERKELEY RENT REGULATIONS COMPARED WITH RENT INCREASES IN OTHER REGIONS AND THE U.S.

	Jan. 1979-Jan. 1995*	Jan. 1981-Jan. 1995*
Berkeley (a.g.a's only)	130%	136%
(with indiv. adj.)	138%	144%
San Francisco-Oakland area	162%	107%
United States	117%	84%
Metropolitan Areas		
Atlanta	117%	74%
Baltimore	114%	91%
Boston	137%	102%
Buffalo	103%	87%
Chicago	126%	97%
Cincinnati	103%	67%
Cleveland	94%	70%
Dallas	90%	57%
Denver	101%	63%
Detroit	112%	62%
Honolulu	155%	123%
Houston	71%	54%
Kansas City	92%	62%
Los Angeles	139%	92%
Miami	104%	56%
Milwaukee	110%	84%
Minneapolis	105%	65%
New York	128%	99%
Philadelphia	131%	103%
Pittsburgh	109%	65%
Portland	101%	74%
St. Louis	93%	63%
San Diego	141%	80%
Seattle	114%	70%
Washington, D.C.	136%	99%

* Source of data for rent increase calculations. Bureau of Labor Statistics, CPI-rent index, all urban consumers (1982-84=100).
In some instances February indexes are used, because the index was bi-monthly.

C. Annual Rent Increase Standards Under Other Rent Control Ordinances

Rent ordinances usually tie annual across-the-board increases to all or a portion of the annual increase in the CPI, rather than setting rents on the basis of operating cost studies.

Across-the-Board Increase Standards Under Rent Control Ordinances

City	Annual General Adjustment Standard
Berkeley	operating cost study noi adj. by 100% of CPI less-shelter
Cotati	operating cost study noi adj. by 100% of CPI
East Palo Alto	100% of lower of rent index or CPI less-shelter
Los Angeles	CPI 3% floor - 8% ceiling
Oakland	3%
Palm Springs	75% of CPI
San Francisco	60% of CPI
San Jose	8%
Santa Monica	operating cost study noi adjusted by 40% of CPI
West Hollywood	75% of CPI

In the early 1980's, Los Angeles, Oakland, San Francisco, and San Jose each permitted annual general adjustments of either seven or eight percent. The Los Angeles, Oakland, San Francisco, and San Jose rent ordinances have always included vacancy decontrol provisions.

D. Considerations in Selecting an Indexing Ratio under Maintenance of Net Operating Income Standards[64]

As previously discussed, the use of the MNOI standard is based on the concept that allowable rent increases for apartment owners should be based on consideration of increases and decreases in apartment expenses and that an apartment owner should be permitted a certain rate of growth in NOI. The use of this concept in order permit a fair return has obtained increasing acceptance over the past decade.

The "dispute" in regards to the MNOI standard has been largely over what rate of indexing should be permitted. This section considers rates of indexing of NOI from various perspectives.

1. The Indexing Concept under Rent Regulations - Historical and Legal Perspective

In past decades, rent controls were subject to the criticism that they did not permit rent increases which were adequate to cover increases in apartment owners' operating expenses. In other words, they were criticized for failing to maintain net operating income. The issue was not whether NOI was permitted to increase at a sufficient rate but rather whether it was being reduced.[65]

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[64] For general discussion of other types of fair return standards and the general rationale underlying maintenance of net operating income standards see. Baar, "Guidelines for Drafting Rent Control Laws: Lessons of a Decade", 35 Rutgers Law Review 721, 781-816 (1983)

[65] For example, one widely used real estate text comments:

> High rates of inflation made millionaires of many property owners in the late 1970's and early 1980's, and low rates of inflation and overbuilding bankrupted many in the middle 1980s. ... This is of little consolation, however, to an owner of rent-controlled apartments in New York or Boston (or scores of other communities) when inflation raises operating costs by 9 percent a year and local authorities either refuse or are slow to permit a pass-through of expenses to the tenant. (Pyhrr, Cooper, Wofford, Kapplin, and Lapides, Real Estate Investment, p. 15 (1989).

In an evaluation of the impacts of rent control in a 1978 article in the Appraisal Journal, the hypothetical projection for the rent controlled building is based on the assumption that net operating income (in absolute dollars) was reduced by 21% over a nine year period. Davidson, "The Impact of Rent Control on Apartment Investment", 46 Appraisal Journal 570,577 (Table 8) (October 1978). (The projection for the non-rent controlled building assumes that in seven of the nine years rents increase by 6%, compared to a 7% annual increase in expenses for the same period. Id. at 572 (Table 2).

Commonly used fair return standards did not consider whether net operating income had increased or decreased. Instead, fair return was measured by rate of return on investment or value, independent of any consideration of whether that return would result in an increase or decrease in NOI compared to pre-rent control levels.[66]

When MNOI standards were used, they only provided for the right to maintain base period net operating income levels, without any adjustment for inflation. Both World War II rent regulations which used the MNOI standard, and the Boston and Brookline MNOI standards of the 1970's, did not provide for any indexing. However, the Cambridge regulation indexed NOI at the full rate of increase in the CPI.[67]

Substantive discussion of the concept of indexing NOI entered the picture in the early 1980's during discussions over the adoption of MNOI standards in California. However, with the exception of the Baker v. City of Santa Monica trial in 1982,[68] the issue of what rate of increase in NOI should be permitted was hardly discussed.

Judicial consideration of fair return issues related to MNOI standards emerged in the context of ordinances which have reduced or frozen net operating income. As discussed below, the judicial response has been that NOI cannot be reduced and/or cannot be "frozen".

In Helmsley v. Borough of Fort Lee,[69] the New Jersey Supreme Court considered the constitutionality of a regulatory scheme which limited annual general adjustments to 2 1/2% per year and had a slow and burdensome individual rent adjustment process. At the time of the case, there was substantial inflation and landlords were incurring substantial increases in operating costs.

The Court found that, as a result of this scheme, "the 'average' landlord can expect profits to fall for the indefinite future."[70] It held that "[a]t some point steady erosion of NOI becomes confiscatory."[71] In an accompanying footnote, the Court noted that: "We do not hold that

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[66] New York used a return on assessed value standard. New Jersey municipalities used return on investment standards.

[67] Boston, Rent Regulation 6,Sec.5(b)(1974); Cambridge, Rent Control Board Regulation 72(1972). (Regulations cited in Baar, supra note 47 at 811, fn. 341 & 343.

[68] No. WEC 058763 (Los Angeles County Superior Court), affirmed 181 Cal.App.3d 972 (1986).

[69] 394 A.2d. 65 (1978).

[70] 394 A.2d. at 76.

[71] Id.

keeping NOI constant (in current dollars) indefinitely is not confiscatory. The effect of such long-term stagnation of profits is not before us."[72]

In Oceanside Mobilehome Park Owners' Ass'n v. City Oceanside[73] and Baker[74], California appellate courts upheld fair return standards providing for growth in NOI at 40% of the rate of increase in the CPI. In the Baker trial, the indexing ratio was the subject of lengthy debate among experts. The expert for the plaintiff contended apartment investors generally expected in an unregulated market that rents would increase at the same rate as the CPI and, therefore, 40% indexing was inadequate to meet reasonable investment expectations. Experts for the defendant testified that historically rents had increased at a slower rate than the CPI, that 40% indexing would provide a reasonable return, and that it was reasonable to index at 40% of CPI, because on the average, 60% of NOI covered debt service payments, which were a fixed cost rather than a cost that increased with inflation.[75] Therefore, 60% of the NOI should not be indexed. In Oceanside the Court found that the fair return standard was reasonable because it allowed an owner to maintain prior levels of profit.[76]

Subsequently, in Fisher, the California Supreme Court held that "indefinitely" freezing net operating income is confiscatory. The Court stated:

> ... although defendants' ordinance may properly restrict landlords' profits on their rental investments, it may not indefinitely freeze the dollar amount of these profits without eventually causing confiscatory results.[77]

While the Court did not consider the issue of what rate of growth in net operating income must be permitted, it did indicate that rent controls may "reduce" the value of property, without violating constitutional safeguards.

> Any price-setting regulation, like most other police power regulations of property rights, has the inevitable effect of reducing the value of regulated properties. But it has

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[72] Id.

[73] 157 Cal.App.3d.887; 204 Cal.Rptr.239 (1984).

[74] Supra note 68.

[75] This author was an expert witness on behalf of the City in Baker, but did not testify on the reasonability of the indexing ratio.

[76] Supra note 73, 157 Cal.App.3d. at 902-905; 204 Cal.Rptr. at 249-251.

[77] Supra note 7, 37 Cal.3d. at 683.

> long been held that such reduction in property value does not by itself render a regulation unconstitutional.[78]

Furthermore, although the Court expressed disapproval of "indefinitely" freezing net operating income, it did not express any disapproval of formulas which permitted less than 100% indexing.

In Searle v. City of Berkeley, the Court of Appeal ruled that based on the evidence in the record, Berkeley's selection of a 40% indexing ratio had no rational basis.[79] The Court commented that:

> The Board also relies on a study which it says "states that since 1913 NOI has historically increased at approximately 32% of the rate of inflation under free market conditions, and since 1970 at about 50% of the rate of inflation." [footnote] ... it must be recognized that the quoted data may be irrelevant to the influence of inflation in the 1970's and 1980's on NOI in the Bay Area. [end of footnote]. These data arguably justify a figure of 50 percent or more, but do not constitute a rational basis for the choice of 40 percent indexing.[80]

However, it did not rule that this ratio denied property owners a fair return and it did not adopt the landlord's position that 100% indexing was constitutionally required. The Court found that neither Fisher nor Cotati "specifies any constitutionally required level of indexing."[81]

At another point, the Court commented that "indexing by less than 100 percent could conceivably be justified, since additional relief would remain available through individual petition for a fair return under revised regulation 1275."[82] However, no such regulation has been adopted.

The next legal challenge to Berkeley's indexing standard came in 1992. While most legal challenges to rent regulations have been brought by landlords claiming that permitted rent increases are insufficient, in this case the City and a tenants group challenged the Rent Board's adoption of 100% indexing as being in excess of its authority. In City of Berkeley v. Berkeley Rent Stabilization Board,[83] the Court concluded that Berkeley's rent control ordinance granted

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[78] Id., 37 C.3d. at 686.

[79] Supra note 9.

[80] Supra note 9 at 138.

[81] Id.

[82] Id. at 142.

[83] 27 Cal.App.4th 951; 33 Cal.Rptr.2d.317 (1994).

the Board the discretion to adopt a 100% indexing formula and that the Board had a substantial basis for its conclusion that 100% indexing was necessary to avoid longstanding confiscation.

However, the Court also declared that "we are not called upon to actually decide whether the Board could have legally decided to *ex*clude debt service; we need only observe that it acted legally when it decided to *in*clude it."[84] Such *ex*clusion signifies indexing at less than 100% of CPI.

In 1995, the California Supreme Court denied a petition for review of an unpublished Court of Appeal decision which rejected a challenge to a 50% indexing standard Ventura's mobilehome rent control ordinance.[85] However, neither the decision nor the denial of review have any precedential weight.

2. Indexing of Net Operating Income - Standards under Other Rent Control Ordinances

Indexing ratios under MNOI standards in rent controlled jurisdictions vary substantially, ranging from 40% to 100% of the percentage increase in the CPI. As the chart below demonstrates, most jurisidictions index by ratios between 50% and 75%.

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[84] Id., 27 Cal.App.4th at 977; 33 Cal.Rptr.2d.at 333.

[85] Pinnacle Holdings v. City of San Buenaventura, 2d Civil No. B083047 (Feb. 1995, Second Appellate District, Division Six.).

INDEXING RATIOS
UNDER MAINTENANCE OF NET OPERATING INCOME STANDARDS
IN CALIFORNIA RENT CONTROL ORDINANCES

City	Indexing Ratio (% of CPI)
Apartment Rent Control Laws	
Berkeley	100%
Cotati	55%
East Palo Alto	100%
Los Angeles	(61%)*
Palm Springs	50%
San Jose	85%
Santa Monica	40%
West Hollywood	60%
Mobilehome Space Rent Control Laws	
Hollister	40%
Lompoc	100%
Milpitas	50%
Morgan Hill	40%
Oceanside	40%
Oxnard	75%
Pacifica	100%
Palm Desert	50%
Palm Springs	50%
Pleasonton	100%
Riverside County	100%
Rohnert Park	60%
Salinas	75%
San Jose	85%
Santa Paula	75%
Santee	
Scotts Valley	60%
Ventura	50%

* Los Angeles uses an index other than the CPI in order to index NOI in its fair return standard. The result is equivalent 61% of the rate of increase in the CPI.

3. Selecting a Reasonable Indexing Ratio

Although there is a demand for a single unquestionable answer as to what index ratio is most reasonable, this author believes such a "discovery" is not possible. The formulation of public policy typically involves competing considerations rather than discovery of one truth. As in other fields of rate regulation or land use regulation, there is no single answer as to what rate of return is reasonable or as to what level of property development must be permitted in order to be reasonable.[86]

This section considers the reasonability of alternate indexing ratios. It is based on the premise that no single ratio is required under judicial doctrine regarding fair return and the cavaet that judicial doctrine can change in the future. It discusses the indexing concept from the perspective of "reasonable investment backed expectations" and "fair return". Also, it comments on the rationale that provided the basis for the Board's current indexing standard.

a. "Reasonable Investment Backed Expectations"

i. Overview

One measure of "reasonable investment backed expectations" may be historical trends in NOI in unregulated rental housing markets. However, statistics on trends in net operating income in the nation or even particular regions have been very limited in time and scope. While there is an index of rents in the Consumer Price Index there is no index of trends in NOI.

Some inferences about trends in NOI may be drawn from trends in rents. If it is assumed that expenses have increased at the same rate as the CPI and that they have equalled half of gross

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[86] In other fields of property regulation, "windfall" and "wipeout" situations often rest on the selection of a number, such as a minimum lot size for a particular type of use or density. Those who fall under the minimum lot size or just outside of a permitted use zone may discover that their permitted use is worth fifty or ninety percent less than those of neighboring property owners who have a lot that is 2% bigger or 100 feet away. Fortunately, the selection of an indexing ratio does not create a line of windfalls and wipeouts.

income,[87] then there have been years during which NOI did not increase, because rents increased at half the rate of the CPI.[88]

Increases in rents at two-thirds of the rate of increase in the CPI, the approximate historical average up to 1980, results in net operating income increasing at about 33% of the rate of increase in the CPI, when operating expenses increase at the same rate as the CPI. The table below sets forth the basis for this estimate.

Rents Increasing at 2/3's of the rate of increase in the CPI Impact on NOI

	Base Year	Current Year	Pct.Inc.
CPI	100	150	50%
Rent Index	100	133	33%
Gross Income	$100,000	$133,333	33%
Expenses	$50,000	$75,000	50%
NOI	$50,000	$58,333	16%

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[87] Nationwide operating expenses typically avergaed about half of gross income. See e.g. annual apartment income/expense reports of the Institute of Real Estate Management (Chicago).

[88]

Rents Increasing at 50% Rate of Increase in CPI
Impact on Net Operating Income

	Base Year	Current Year	Pct.Inc.
CPI	100	150	50%
Gross Income	100,000	125,000	25%
Operating Exp.	50,000	75,000	50%
Net Oper. Inc.	50,000	50,000	0%

When rents increase at three-quarters of the rate of increase in the CPI, the approximate average from the beginning of the CPI rent index to the present, NOI increases at 50% of the rate of increase in the CPI.[89]

As previously indicated, since 1980 the national rate of increase in rents has approximated the rate of increase in the CPI. In areas where costs increased at the same rate, NOI would have increased at 100% of the rate of increase in the CPI. However, in a substantial portion of metropolitan areas rents increased at a rate well below the national average. Furthermore, to the extent that Berkeley's growth in apartment operating expenses at more than 100% of the rate of increase in the CPI was replicated elsewhere, rent increases at the rate of increase in the CPI might not have been enough to permit NOI to increase at the same rate as the CPI.

Other evidence also may support the conclusion that on a national level NOI has not typically increased at the same rate as the CPI. Reports of the Institute of Real Estate Management (IREM), the most extensive source on apartment income and expenses in the U.S., indicate that net operating income/gross income ratios decrease as buildings become older. Alternatively stated, operating expenses consume greater shares of gross income as buildings age.

For example, 1993 IREM data indicates that the median NOI ratio for garden type buildings constructed before 1978 was approximately 45%, while the median ratio for buildings constructed 1978 or later was 51%.[90] Low-rise buildings with over 24 units experienced similar differences in ratios between buildings constructed before and after 1978. Data from IREM's 1981 report indicated that NOI ratios were 15 to 20% lower for pre-1946 buildings than for buildings built since 1968.[91]

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Rents Increasing at 3/4's of the rate of increase in the CPI Impact on NOI

	Base Year	Current Year	Pct.Inc.
CPI	100	150	50%
Rent Index	100	133	37.5%
Gross Income	$100,000	$137,500	37.5%
Expenses	$50,000	$75,000	50%
NOI	$50,000	$58,333	25%

[90] Institute of Real Estate Management, Income/Expense Analysis, 1993, Conventional Apartments (Chicago), pp. 208,210,212,&214. (1,661 buildings in the sample were constructed between 1946 and 1977, of which 1,355 were constructed between 1965 and 1977. 1,741 buildings were constructed 1978 or later.)

[91] IREM, Income/Expense Analysis: Apartments (1981), p.34.

Apparently, the City of Boston recognized that older buildings have lower NOI/Gross Income ratios. Under Boston fair return regulations which designated a particular net operating income ratio as fair, a higher ratio was used for newer buildings.[92]

A recent analysis of net operating income trends in Los Angeles, based on Franchise Tax Board data, concluded that "real NOI", i.e. NOI adjusted for inflation, fell by 4.8% between 1984 and 1992.[93] During the first half of that period, from 1984 to 1988, "real" NOI increased. From 1988 through 1992, "real" NOI fell by 16%.[94] The analysis stated that "... the striking shifts in vacancy rates, real rent levels and construction of new multi-family units suggest the possibility of similarly dramatic shifts in the financial performance of stabilized rental housing." It attributed a downturn in "real" NOI from 1988 through 1992 to "... the onset of the recession and generally weakening rental market."[95]

Observations of the author of one widely used real estate text would tend to support the conclusion that NOI does not increase at the same rate as the CPI. In his text, the author comments that, "... as a property ages and has higher functional obsolescence, revenues are adversely affected. ...both age and inflation work to increase operating expenses. ... Consequently, it is generally true that operating expenses tend to rise at a more rapid rate than revenues over the holding period."[96]

While the foregoing discussion sets forth evidence that NOI does not typically increase at the same rate as the CPI, information from selected time periods and/or alternate data sets may support varying conclusions about trends in NOI relative to the CPI. However, what is very notable is that a review of the available information and of real estate literature clearly reveals that there is no general investor or market expectation that NOI will increase at the same rate as the CPI.

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[92] Boston, Mass. Rent Regulation ch. 842 Sec.5(b) (1974).

[93] Hamilton, Rabinovitz, & Alschuler, Rental Housing Study 1994 (Los Angeles Housing Department Rent Stabilization Division). This calculation was made by the author using the data contained in the H.R.& A. report. The chart indicates that "Real" NOI levels were $3,057 in 1984; $3,480 in 1988; and $2,910 in 1992.

[94] Id.

[95] IREM data for the same period showed that NOI kept up with the CPI from 1988 through 1992. Id. at 101 (Chart 31). The differences in results between the two data sources were attributed to differences in the samples from each source. IREM obtained its data from large professionally managed buildings, while the FTB sample was limited to individual property owners (excluding partnership and corporate returns.) Id. at 184-185.

[96] Wurtzebach and Miles, Modern Real Estate, 569 (1994).

ii. Replication of U.S. Rent Trends Since 1979 (when rent regulations were adopted in Berkeley)

One approach to establishing a reasonable rate of indexing may be to consider rent increase trends nationwide, since rent controls were instituted in Berkeley in 1979. Use of this approach incorporates regions with varying levels of competitive markets, in terms of land availability and regulatory constraints on multifamily construction.

At the same time, it should be noted that there is no generally accepted definition of a competitive or "equilibrium" market.[97] In economic theory, there may be a perfect market where suppliers and consumers are free to enter and leave the market, without outside compulsion or interference. By the very nature of its lack of elasticity, land for housing construction can hardly fall into this model. Furthermore, the supply is heavily regulated in urbanized areas.[98]

Use of San Francisco area trends in rents and NOI as a guide as to what rent increases would be reasonable suffers from the conceptual shortcoming that an underlying premise of rent regulation is that the local housing market is not functioning in a competitive manner. Restrictions on apartment construction are particularly stringent. Under these circumstances, incorporating a San Francisco rent index into a measure of fair return or a concept of "equilibrium market" would be to incorporate into the regulation the same the housing shortage factors that led to regulation. In the past fifteen years, rent increases in the San Francisco area have substantially exceeded national averages. For example, as indicated in the Table on page 22, from January 1979 through January 1995, the San Francisco rent index increased by 162% compared a 117% increase in the national rent index.

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[97] In 1975, the New Jersey Supreme Court declared that apartment owners were entitled to a fair return on:

> ... the value of the property in a rental housing market free of the aberrant forces which led to the imposition of controls. ... [i.e.,] the worth of the property in the context of a hypothetical market in which the supply of available rental housing is just adequate to meet the needs of the various categories of persons actively desiring to rent apartments in the municipality. (Troy Hills Village v. Township Council of Parsippany-Troy Hills, 68 N.J. 604; 350 A.2d.34 (1975).

Three years later, however, the same court concluded that a "value-based criterion is practically unworkable" in a rent control context. Helmsley v. Borough of Fort Lee, 78 N.J. __,215; 350 A.2d.50,72 (1978). With regard to the task of "estimating value in a hypothetical market where supply and demand are in equilbrium", the Court observed that "none of the [expert] witnesses had performed such an analysis before; none knew of any recognized appraisal method for making such hypothetical equilibrium valuations." Id.

[98] Federal Commissions have repeatedly concluded that local zoning regulations excessively restrict the supply of multifamily housing. See e.g. Advisory Commission on Regulatory Barriers to Affordable Housing, "Not in My Back Yard" (1991); The Report of the President's Commission on Housing, pp. 199-208 (1982).

If national rent trends are used as a gauge of reasonability, then the allowable increase in Berkeley rents from January 1979 through January 1995 would have been 117%[99] instead of the 130% increase permitted.[100] In such a case, the increase in NOI would have been less than 100% of the rate of increase in the CPI.

If Berkeley's across-the-board adjustments had paralleled national trends, then the increase in rents would have been from $239 to $519, rather than to the $549 level actually permitted.[101] In such a case, the NOI increase would have been $30 lower;[102] it would have been from $136 to $274, rather than from $136 to $304. The NOI increase would have been approximately 101% compared to the 127% increase in the CPI all-items or approximately 80% of the increase in the CPI.

If overall rent adjustments, including individual rent adjustments, had equalled the national average of 117%, then the amount of required indexing of NOI through the annual general adjustment process would have been lower.

b. Providing a "Fair Return"

i. Overview

The indexing issue may also be viewed from an overall fair return perspective. Often courts and ordinances use the terms "fair return on investment". However, fair return analysis under California rent regulation has usually not involved a calculation of the rate of return on investment because such an approach is "circular" in the context of regulation. If a certain rate

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[99] Jan. 1979 - CPI,rent residential - 71.9; Jan. 1995 - 156.1.

[100] Rent controls cannot be considered as a significant constraint on the national rate of increases. Nationwide, about 10% of all rental units are subject to rent controls. A substantial portion of those units are under regulations which include vacancy decontrol provisions.
Analysis that was performed in the early 1980's indicated that generally, rent increases in rent controlled jurisdictions had equaled or exceeded national averages. See Baar, supra note 47 at 745-749.

[101] The pre-rent regulation median rent is estimated by subtracting the allowable increases from 1995 median rent for units that did not receive individual rent adjustments. The 1995 median rent estimate is equal to the $541 median estimated in the 1994 annual general adjustment report, adjusted by the 1.5% rent increase permitted in January 1995.

[102] Here 1979 NOI is estimated to be approximately the same as the 1981 NOI of $136. The 1981 annual general adjustment was designed to offset operating cost increases. The 1980 ordinance permitted a passthrough in operating expense increases subject to a ceiling equal to 5% of the rent. The basis for the estimate of the 1981 NOI is set forth in note 33, supra. 1995 NOI was estimated at $304 in the annual general adjustment study based on a median rent estimate of $549.

of return on investment is guaranteed, the investment (and, therefore the investor) determines the allowable rent. Furthermore, a rate of return formula discriminates against long term owners.[103]

As opposed to setting a fair rate of return, the MNOI approach regulates the rate of growth in the return. The rate of return is set by a combination of the investor's decision and the rate of growth in return that is permitted. The question of whether a certain rate of indexing permits a fair return may be evaluated by considering its impact on growth in return (rather than calculating a rate of return).

In evaluating fair return concepts it is critical to understand the differences between real estate investments and other types of investments. As real estate texts standardly note, the components of return on real estate investments include cash flow, appreciation and tax shelter benefits. In contrast, returns on stock investments, which usually are unleveraged, are limited to cash flow and appreciation (or depreciation). Bonds offer a nearly certain return of the principal at the end of a given period; however, during the term of a bond, its market value may increase or decrease substantially based on fluctuations in interests rates in the bond market. Bank deposits offer cash flow and an insured return of the original principal, without appreciation or depreciation.

When the real estate industry examines investment performance it considers rate of return on investment, typically measured by "internal rate of return".[104] Except, in rare cases, it does not compare growth in NOI with the percentage increase in the CPI.[105]

ii. The Leveraged Nature of Real Estate Investments

The "leveraged" nature of real estate investments allows investors to receive a reasonable return on their investments when increases in NOI are well below the rate of increase in the CPI. As a result of the leveraging factor, the increase in equity may be a multiple of the rate of increase in the net operating income and value of the property.

The clearest hypothetical illustrating these realities may be a house purchase with a 20% downpayment (original equity). For example, if a house is purchased for $100,000 with a

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[103] In some instances, suggestions have been made to index the investment for inflation when determining whether a property yields a fair rate of return. However, in practice, Rent Boards have rarely used this approach.

[104] The "internal rate of return" methodology computes return by discounting all cash outlays and cash flows associated with the ownership of a property, including proceeds from the sale of a property.

[105] A review of real estate textbooks and articles on rate of return in real estate journals confirms this conclusion.

$20,000 downpayment, a 20% increase in value will result in a 100% increase in the owner's equity (from $20,000 to $40,000).

As the hypothetical below illustrates, if an investor purchases an apartment building for $500,000 with a 30% ($150,000) downpayment, a 20% increase in the NOI which leads to a 20% ($100,000) increase in the value of the dwelling will lead to about a 66% increase in equity. In this case the investor's equity has increased from $150,000 to $250,000. However, some of the increase in equity may be consumed by sale costs. For example, the increase in equity may be reduced from $100,000 to about $60,000. As a result, the net return on equity may be 40% in this case (a $60,000 increase in equity compared with a $150,000 investment).

INCREASES IN CPI, NOI, VALUE, AND EQUITY COMPARED

	Base Year	Current Year	Pct. Increase
CPI	100	150	50%
NOI	$45,000	$54,000	20%
Value	$500,000	$600,000	20%
Mortgage	$350,000	$350,000	0%
Equity	$150,000	$250,000	66%
Equity Adjusted	$150,000	$210,000	40%

One may debate about the particular numbers in the above hypothetical. The critical concept is that, due to leveraging, equity may increase at a multiple of the rate of increase in value. In terms of an indexing ratio, the reality of leveraging may result in equity increasing at a rate that approximates or exceeds the rate of increase in the CPI, even though NOI is increasing at a rate well below the rate of increase in the CPI.

In the case of Berkeley, the 200% appreciation in apartment values since the mid-1970's[106] has enabled investors to obtain substantial growth in equity relative to leveraged cash investments. For example, pre-rent control investors who paid $15,000 per unit, with cash investments of $5,000 per unit and mortgages of $10,000 per unit, may now have units with a

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[106] See table on p. 11.

value of $45,000 and equities in the range in the range of $36,000 per unit. The $30,000 increase in equity is a substantial return relative to the $5,000 cash investment.

In the case of purchases made in the 1980's, the appreciation is in the range of 50%.[107] For example, in the case of a $30,000 purchase price with a cash downpayment of $10,000 (and a mortgage of $20,000), current value is now at a level of $45,000 and equity is at a level of $25,000. In this case,the appreciation in value and equity of $15,000 would compare with a cash investment of $10,000. The following tables illustrate the relationships between original investment and current equity that are based on the foregoing hypotheticals. In both cases, the annual rate of growth in equity would be approximately 10%. In dollar terms, the average annual rate of increase in equity is $1,500 per year.

Appreciation Compared with Cash Investment
Hypothetical Berkeley Apartment

	Apt. A	Apt. B
Purchase Date	1975	1985
Purchase Price	$15,000	$30,000
Mortgage	10,000	20,000
Original Equity (downpayment)	5,000	10,000
1995 Value	45,000	45,000
1995 Equity (1995 value - mtg.)	35,000	25,000
Annual rate of growth in equity (compound rate)	10.2%	9.6%

In addition to growth in equity, apartment investors have received other types of return from real estate investments - cash flow and tax shelter benefits. The monthly increases in NOI, which have been provided in the past five years (and translate into increases in cash flow) have increased monthly NOI levels per unit by about $150 (increasing annual NOI levels per unit by $1,800). From an investment perspective, the yields on the cash investments ranging from $5,000 to $15,000 include $1,500 a year in appreciation and an annual cash flow increase of $1,800 between the base year and 1995. These returns are respectable and certainly are far superior to the returns yielded by more conservative and passive investments such as bonds.

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[107] See Table on p.11.

One may debate about each aspect of the "average" cases presented here. Sale costs may reduce returns. Greater leveraging may raise the rate of growth in equity. Conversely, larger downpayments reduce the rate. Properties have appreciated at varying rates. However, in any case, for typically leveraged investors, the appreciation in value remains highly respectable relative to the amount of cash invested.

Comparison of the appreciation in Berkeley apartments with appreciation of apartments in other markets is difficult because comprehensive data on trends in apartment values is very limited.[108] Generally, real estate literature indicates that there were very high rates of return in the late 1970's and early 1980's. The limited sources of empirical information indicate that the scenario has been far different in the past decade. The most widely used index of trends in the value of investment real estate is the "Russell-NCREIF Property Index", which measures appreciation of properties held by institutional investors. Its reports indicate that property values have remained level from 1983 through 1991.[109] Data from COMPS InfoSystems, a real estate information service for appraisers, indicates that apartment values in San Diego County increased from $38,299 per unit in 1984 to $54,131 per unit in 1990 and then declined to $34,002 in the 1994-95 period.[110] Data from this service for other areas was limited to more recent time periods. Generally, it indicates that apartment values have remained level during the past five years.[111] Further research would be required to determine precisely how the appreciation in Berkeley apartments from the pre-rent control periods to the present compares with the appreciation in other areas.

iii. **Debate Over Whether The Mortgaged Share of NOI Should be Indexed**

Over the years, indexing at less than 100% has been justified on the basis that, on the average, more than half of NOI covers debt service which is a fixed cost. The underlying concept is that the return on the mortgaged portion of the investment should not be indexed because the cost of that portion of the investment is fixed and does not reflect an actual cash investment by the

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[108] For discussion of available data on real estate returns see Wurtzbach and Miles, "Real Estate and Modern Portfolio Theory", Modern Real Estate (Ch.22) (1994).

[109] See e.g. Diehl, "The Russell-NCREIF Property Indices: Institutional Real Estate Performance Benchmarks", 1 Journal of Real Estate Literature 95 (1993) (Table 1, p.102, indicates that values increased by 7% from 1983 through 1991. (The table does not include periods prior to 1983.)

[110] Report prepared by COMPS Infosystems,Inc.(San Diego, Oct. 12, 1995) at the request of this author. The sample included over 200 buildings with over 3,000 units in each year. It was limited to buildings with between 7 and 29 units which were constructed in 1980 or earlier.

[111] Id. Average apartment values for units in buildings with between 7 and 29 units constructed 1980 or earlier were as follows: Alameda County - 1989 $51,385, 1994-95 $48,018 (sample sizes 123 to 125 buildings); Santa Clara County - 1988 $65,566, 1994-95 $68,747 (sample sizes: 124 and 81 buildings respectively).

owner. This was one of the principle rationale used to justify Santa Monica's 40% indexing standard which was upheld in Baker v. City of Santa Monica.[112] In that case, the Board presented evidence, based on debt service data contained in apartment owner's registration forms, that on average 40% of NOI was cash flow and 60% was devoted to debt service.

A decade after the 40% indexing standard was implemented the Court of Appeal commented, in dicta, that it could not accept the Board's rationale for the exclusion of debt service and stated that "... debt service is a factor which appears relevant to the determination whether, in fact, a landlord is receiving a fair return."[113]

In City of Berkeley v. Berkeley Rent Stabilization Board the Court of Appeal specifically stated that it was not reaching the issue of "whether the Board could have legally decided to exclude debt service" from an inflation adjustment.[114] But, it did rule that the Board had the discretion to index the mortgaged portion of NOI, based on the rationale presented by its consultants.[115] Furthermore, the Court commented:

> It would surely be strange if this system purportedly designed to maintain the real value of MNOI were used concededly to erode it. Second, as the economic analyses and evidence before the Board showed, debt service and finance costs are not always fixed; the availability of variable rate loans causes debt service costs to rise with interest rates, which generally move in tandem with inflation rates. Third, the system of full and uniform indexing for AGA adopted by the Board has the advantage of neutrality as to the nature of the property owner's financing arrangements; it need not distinguish between properties owned free and clear, those encumbered by recent mortgages, or those in between.[116]

These statements, if read alone, would seem to mandate indexing of the debt service portion of net operating income and, therefore, 100% indexing of NOI. However, as noted, these comments were in the context of review of the Board's discretion to uphold 100% indexing and the Court's qualification that it was not ruling that 100% indexing was required.

The H.R.& A. report presented rationale for and against indexing the portion of the NOI devoted to debt service and straddled the line in its analysis. Its report focused on the issue of

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[112] 181 Cal.App.3d.972,988; 226 Cal.Rptr.755,765 (1986).

[113] Kavanau v. Santa Monica Rent Control Board, ___ Cal.App. __,___ n.3; 23 Cal.Rptr.724,725-726,n.3 (1993).

[114] Supra note 83, 27 Cal.App.4th at 976; 33 Cal.Rptr.2d. 332.

[115] Supra note 83, 27 Cal.App.4th at 975; 33 Cal.Rptr.2d. at 332.

[116] Supra note 83, 27 Cal.4th at 975; 33 Cal.Rptr. at 332.

whether individual rent adjustments should take debt service into consideration.[117] In this report, the question of whether the debt service portion of NOI should be indexed is folded into the larger issue of what indexing ratios are needed in order to permit a fair return.

Issues Related to Variable Rate Mortgages

Questions have been raised over whether the debt portion of NOI should be indexed because mortgage interest rates are generally variable under the mortgages that are available to apartment purchasers. As indicated in Section II of this report, virtually all apartment financing has been with variable rate mortgages and that has been the only available form of financing, with rare exceptions. Discussions of the debt service issue often assume, explicitly or implicitly, that the "variable rate" mortgage is an increasing cost for apartment owners.[118]

In fact, the rates in variable rate mortgages vary upwards and downwards. There are substantial reasons for not factoring variability of mortgage rates into the across-the-board rent setting process and/or allowing for greater indexing ratios in order to address the variability factor. These include the following:

- While mortgage costs of apartment owners increase due to "variable" rates at certain times, they decrease at other times. Consistent treatment of variability would require rent decreases to offset decreases in mortgage interest rates as well as increases in rents to cover upward movement of rates.[119] Under the current policy, apartment owners obtain the fruits and bear the burdens of variations in interest rates. It seems reasonable that these risks should be borne by investors, who obtain the mortgages and have more control over them, rather than by tenants.

- Apartment prices increase and decrease in response to changes in interest rates. New investors may offset increases in interest rates by paying lower prices or have to pay higher prices when interest rates decline. In effect, market factors offset variations in interest rates, at

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[117] This author has consistently recommended against consideration of the financing arrangements of individual buildings in individual rent adjustment determinations. Courts have repeatedly held that rent setting schemes that discriminate between individual owners based on financing arrangements have no rational basis. For a recent example see Palomar Mobilehome Park Ass'n v. City of Palomar, 16 Cal.App.4th 481,488; 20 Cal.Rptr.2d.371,374-375 (1993). However, other court decisions seem to command consideration of debt service. See e.g. Kavanau, supra note 113.

A response to public comments regarding the concept of higher indexing ratios for owners who own their properties free and clear of debt is contained in Appendix A.

[118] The issue of variability in mortgage interest payements should not be confused with the issue of increasing mortgage costs due to larger mortgages.

[119] As far as this author is aware, none of the advocates of consideration of variability has suggested that rents should be adjusted downward to cover drops in interest rates.

least at the time of purchase. Also, to the extent that rents, as well as interest rates, rise at a greater rate in times of greater inflation, increases in interest rates may be offset by greater appreciation in value. (Of course, these are not universal patterns. Sometimes interest rates increase without offsetting increases in rents and property values.)

- During the course of apartment ownership financing costs are "relatively" fixed. The principal under a mortgage does not increase when rents and apartment owner's equities increase nor is it adjusted to reflect the decline in the "real" value of the amount due.[120]

iv. Comments on Specific Indexing Ratios

As previously indicated, there is no single "correct" answer about what rate of indexing would be the fairest or most desireable from a policy perspective. Comment on specific indexing ratios is subject to the that no single ratio can be pointed to as uniquely correct or superior to all other ratios, just as there is no single "correct" answer in regulations regarding the minimum wage, maximum hours, minimum lot sizes, or utility rates. Competing policy considerations are at stake. Science cannot provide a single fair and just answer in this policy area (and most others).

100% Indexing

Rationale for 100% indexing was provided to the Board in Hamilton, Rabinovitz, & Alschuler, "Inflation Indexing in Berkeley Rent Regulation in the Aftermath of the Searle Decision" (Aug. 19, 1991) (Hereinafter referred to as the "H.R.& A. report"). That rationale, which was relied on by the Court of Appeal in upholding the the Board's discretion to adopt an 100% indexing was that:

> Put simply, it is a mathematical certainty, not an assertion, that any system which provides for full adjustment to inflationary changes in operating costs and only partial indexing of landlord NOI to general price inflation will, unless operating costs pursue a sustained course opposite to general price trends in the economy, result in erosion of the real value of the NOI.[121]

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[120] In some nations, commonly used mortgage forms provide for adjustment of the principal in accordance with inflation.

[121] H.R.& A. report as quoted in Berkeley v. Berkeley Rent Stabilization Board, supra note 83, 27 Cal.App.4th at 964; 33 Cal.Rptr.2d. at 325.

H.R.& A. commented that erosion of the real value of the NOI will be capitalized into "declining real property values" [emphasis added].[122] In other words, the H.R.& A. report reasoned that a loss has occurred if value does not increase at the rate of inflation (as measured by the CPI). (However, in its analysis, even its concept of "real" became an adjustable concept by virtue of its selection of an alternate CPI index that differed significantly from the standardly used CPI all-items index. In essence, two differing possible answers were provided to the question of how "real" values had to be preserved.[123])

While the H.R.& A. report used a concept of preserving "real" value that may have some acceptance, it is not a concept that has guided real estate investment analysis (nor does it guide the concept of investment analysis in real estate textbooks). In the real estate world, the reasonability of returns has been viewed from a return on investment perspective, rather from the perspective of whether or not NOI has increased by the same rate as the CPI. As the hypotheticals in this report illustrate, return on investment may be more than satisfactory when NOI is increasing at less than the full rate of increase in the CPI, due to the leveraged nature of real estate investments.

Also, the concept that regulation must permit value to increase at the same rate as the CPI has not guided basic property rights and fair return concepts. In regards to fair return concepts, in Fisher v. City of Berkeley, the State Supreme Court stated that price regulations have the inevitable effect of reducing the value of regulated properties and that "such reduction in property value does not by itself render a regulation unconstitutional."[124] The concept that NOI must be permitted to increase at the same rate as the CPI, because otherwise real value will be lost, appears to be directly contrary to this decision by the Court.

Other Indexing Ratios

65% - 70% indexing

The Rent Board requested analysis of alternate indexing ratios and their rationale. As illustrated by the hypotetheticals in this section, indexing at less than the full rate of inflation still permits growth in equity that exceeds the rate of inflation, as long as substantial leveraging of the investment is possible. Prospective indexing at 65% of the rate of increase in the CPI would allow current owners with typical leveraging ratios to realize a future rate of growth in current equity approximately equal to the rate of increase in the CPI.

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[122] H.R.& A. Report, p.47.

[123] H.R.& A. Report, pp. 31-34.

[124] 37 Cal.3d. at 686; 209 Cal.Rptr. at 715.

The average equity to value ratio for Berkeley apartment owners is most probably in the range of 65%. This is the ratio in cases of units purchased for $30,000 with a $10,000 downpayment, an original mortgage of $20,000, and a current value in the range of $45,000.[125] The $30,000 price range prevailed in the late 1970's and most of the 1980's. (The median purchase date for apartments is about 1980.) For the purpose of this analysis, it is assumed that current equity is in the range of $30,000 ($45,000 value minus $15,000 balance on mortgage).[126]

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[125] See discussion of financing ratios on p. 12, infra.

[126] Under a 30 year amortization schedule 9% of the principal is paid off in the first ten years, 18% is paid off after 15 years, 33% is paid off after 20 years, and 59% is paid off after 25 years.

Indexing NOI at 65% of Increase in CPI
Impact on Value and Equity
(65% equity, 5% annual increase in CPI)
(10 year period)[127]

	Year 1	Year 10	Annual rate of increase
CPI index	100	163	5%
NOI index	100	141	
Value	45,000	63,450	
Mortgage	15,750	15,750*	-
Equity	29,250	47,700*	5%

* These amounts do not reflect increases in equity due to principal payments on the mortgage made during the ten year period.

In the case of owners with a 65% equity to value ratio, indexing at 65% ratio will permit equity to increase at the same rate as the CPI. In other words, it will preserve the "real" dollar value of the current equity. Indexing by an additional 5% would provide some growth in NOI for additional principle invested in the form of principal payments on the mortgage.[128]

In the case of new purchasers who made 33% cash down payments, growth in equity would be at about 1 1/2 times the rate of inflation. The precise relationship between growth in equity and inflation would depend on the rate of inflation. As rates of inflation increase, the ratio of equity growth to inflation declines; however, with increasing inflation the rate of return relative to the original investment increases.

In the event of 5% annual inflation over the ten year period, the investors equity would increase at the rate of 8.3% per year. At the end of the ten year period, the investors' equity would have increased by 123% at the same time that the value of the dollar would have decreased by 63%.

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[127] In this table it is assumed that the 65% ratio of increase in NOI would be calculated in relation to a base rather in relation to each prior year. Otherwise, the indexing ratio would be gradually reduced over time due to compounding factors. For example, with a five percent annual increase in the CPI, the increase over 10 years would be 63%. If NOI were indexed by 3.25% (65% of 5%) year, the increase over 10 years would be 37.6%, which would be 59% of the increase in the CPI.

[128] Calculation of the amount of additional principle payments made during the next ten year period would be speculative due to variable interest factors and because it is likely that a substantial portion of the properties would be sold during the ten year period, in which case they would most likely obtain more favorable leveraging ratios.

Indexing NOI at 65% of Increase in CPI
Impact on Value and Equity
(33% equity, 5% annual increase in CPI)
(10 year period)

	Year 1	Year 10	Annual rate of increase
CPI index	100	163	5%
NOI index	100	141	
Value	45,000	63,450	3.25%
Mortgage	30,000	30,000*	
Equity	15,000	33,450*	8.3%

* These amounts do not reflect increases in equity due to principal payments on the mortgage made during the ten year period.

The use of a 70% indexing ratio under circumstances in which the operating costs increased at the same rate as the CPI would result in rents increasing at approximately 82% of the rate of increase in the CPI.[129] This rate of increase relative to CPI would be lower than the ratio of the last decade, but would be comparable to the overall ratio for the period from 1950 to 1990.

Indexing Ratios Between 70% and 100%

Depending on what time period and what region is chosen and what assumptions are made varying indexing ratios can be justified as replicating market conditions. What is clear from the data is that NOI increasing at 100% of the CPI is not a standard market reality or expectation. Indexing at rates which are below 100% of CPI, but are above typical equity to value ratios, can provide reasonable returns on investment. Until rent control emerged in California, there was no significant precedent for the argument (or concept) that real estate investment was a loss because value was not increasing at the same rate as the CPI.

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[129] For each one percent increase in the CPI, each dollar in rent would be increased by $0.42 in order to adjust net operating income (.70 indexing ratio x .60 NOI ratio) and $0.40 to cover operating cost increases (1.00 (full operating cost passthrough) x .40 operating cost ratio.) The 60% NOI ratio approximates the ratio for Berkeley units. The annual general adjustment reports project a ratio of approximately 55%, but do not include individual rent adjustments in estimating average NOI.

In light of the trends of recent decades in various regions, which have been marked by over construction, real estate booms, real estate crashes, and widespread foreclosures on apartment investments in some areas, indexing ratios of 70% or higher will provide attractive returns and growth in equity exceeding the CPI for most owners.

While the returns that might be offered under such regulations may not be as high as the returns realized in other parts of the San Francisco Bay Area, they may be considered reasonable from a broader perspective. The Bay Area increases in rents have been exceptional by national standards. In the Berkeley area, land use regulations, a lack of additional land space, high land costs, and high construction costs virtually preclude competition from new apartment construction.[130] As a result the risk of loss (vacancies) as a result of new competition and "overbuilding" is drastically reduced, if not virtually eliminated. In other words, while there is some risk that future regulations may impact returns, there is virtually no risk of new competition.

v. Perspective on the Indexing Issue

Ironically, if Berkeley had tied its annual general adjustments to 100% of the rate of increase in the CPI there would have been no question about the legitimacy of the approach and the result would have been less favorable to apartment owners than the current approach. However, its annual operating cost studies have demonstrated that annual general adjustments of more than the full CPI were necessary in order to permit NOI to increase at the same rate as the CPI.

In the world of business and real investment, growth in profit at less than the rate of increase in the CPI has not been considered as a "loss". One would not read in the Wall Street Journal that General Motors suffered a loss last year because its profits only went up 4% compared to a 6% increase in the CPI. Likewise, real estate investment is not seen as a loss when value increases at less than CPI.

Instead of comparing growth in NOI with the CPI, real estate investors look at their rate of return on the cash they have invested. As previously discussed these returns may be well above the rate of inflation even when properties appreciate at less than the full rate of inflation due to the leveraged nature of real estate investments.

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[130] Berkeley's 1990 Housing Element (pp. III-18 - 19) projected that the cost of a two bedroom (850 square foot) apartment is in the range of $110,000 to $180,000. (The Housing Element is an official report approved by the City Council.) Furthermore, the amount of new multifamily construction in Berkeley and many neighboring areas is severely restricted by planning regulations which take into account overall environmental and neighborhood concerns.

IV. Individual Rent Adjustment (IRA) Standards

In the first six years that IRA petitions were accepted under the ordinance (1981 through 1986), 515 petitions were filed for individual rent adjustments, compared to 830 petitions filed during the next four years (1987 through 1990), and 1,567 petitions filed during the following four and half years (1991-June 1995)

Information on adjustments prior to 1987 has only been partially entered into the Rent Board's computer data base. The chart below provides data on the types of individual rent adjustments granted in each year, starting with 1987. It is important to note that the numbers of adjustments in the table exceed the numbers of units that have received individual rent adjustments because petitions for increases are typically based on several types of standards.

Some trends are particularly worth noting. After the adoption of 40% indexing and certification of rents in 1987, the number of NOI adjustments was substantial. However, their volume dropped drastically after the Searle increase in 1991. From 1993 through June 1995 approximately two-thirds of all the types of individual rent adjustments have been for capital improvements. In 1994 and the first half of 1995, 2,132 capital improvements increases were granted. 1,012 units obtained historically low rent (HLR) increases in 1992, the year after the regulation was adopted. However, since then their level has dropped to about 250 per year.

Types of Individual Adjustments - 1981-June 1995
(Number of Units Granted Each Type of Adjustment)*

	NOI	Cap. Imp.	Tax Inc.	Ten Inc.	Low Rent	Debt Serv.	Serv	Occ	HLR
1987	153	321		0	50	11	10	72	
1988	683	660		0	15	35	26	43	
1989	427	629		0	45	43	89	36	
1990	571	806	118	30	21	50	111	34	
1991	651	1078	395	19	33	1	113	22	9
1992	149	779	317	16	6	0	36	19	1012
1993	143	1172	284	66	0	0	15	67	227
1994	137	1110	303	48	0	0	37	48	260
1995(Jan-June)	45	1022	197	8	1	0	13	8	116
Total	2559	7577	1614	187	171	139	450	349	1646
Avg. Increase	$51	$50	$19				$62	$62	$65

* Spaces in the table are left blank in years when the type of individual adjustment was not authorized.

A. Capital Improvements Increases

This first part of this section describes Berkeley's capital improvement standard. The second section provides data on the volume, amounts, distribution, and types of work involved with capital improvement increases under Berkeley's ordinance. The third section discusses basic issues in the design of capital improvements standards. The fourth section describes policies and capital improvement increases in other rent controlled jurisdictions. The fifth section comments on issues and options for Berkeley.

1. Berkeley's Capital Improvement Standard

Under the MNOI regulations in effect until 1991 capital improvements were considered within the context of maintenance of net operating income applications. Essentially, capital improvements were treated in the same manner as other operating expenses, except that they had to be amortized, rather than being expensed in one particular year.[131] In 1991, the regulations were amended to provide for consideration of capital improvement expenses independently of any consideration of net operating income.

Capital improvements are defined as:

> ... any improvement to a unit or a property which has a useful life of more than one year and a direct cost of $200 or more per unit affected, or $1,500, whichever is less.[132]

An interest allowance is included, with the rate equal to the actual rate paid by the owner for a loan to finance the improvements. If the landlord finances the improvement an interest rate of 10% is imputed.[133] Increases are in effect for the amortization periods set forth in the regulations, which range from 5 to 15 years.[134]

An increase petition for a particular improvement may be made years after the improvment is completed. However, the amortization period for any improvement completed after June 1, 1993 starts to run no later than two years after it is completed. The results of this rule are that the total amount of the amortization period for a capital improvement may extend two years

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[131] If capital improvements could be expensed in one year, the MNOI standard could be manipulated by grouping capital improvements into one year.

[132] Section 1267.(B)
Standard qualifications of this definition are set forth in Section 1267. (C).

[133] Sections 1267.(E) & (F).

[134] Regulations, Appendix A, Jan. 10, 1992.

beyond the life of the improvement. However, the total increase allowed for an improvement will be diminished if the petition is made more than two years or more after it is completed.

For example, if an improvement with a five year life is completed in 1994, a petition for an increase for that improvement may be made in 1998. In such a case the amortization period will begin in 1996. Between 1998 and 2001 the owner will be able to charge for last three years life of the improvement even though the "life" of the capital improvement would have ended in 1999.

In the case of improvements completed before June 1, 1993, for which increases have not already been obtained, the amortization period begins on June 1, 1995 or five years after the completion of the improvement, whichever is earlier.

2. Data on Capital Improvement Increases in Berkeley

a. Number of Increases Granted and Amounts of Increases

A total of 4,770 units have been granted for capital improvements increases since 1987. A substantial portion of these units have received more than one increase; a total of 7577 capital improvement increases have been obtained by the 4,770 units. (The data on capital improvements increases in the following tables takes into account 314 capital improvements increases granted before 1987 which have been entered into the Rent Board's data base.)

b. Range and Distribution of Increase Amounts

While the average rent increase for capital improvements has been $50, the median increase has been approximately $25.00. The average is far higher than the median because 11% of the increases were $100 or more, while nearly a quarter of the increases have been less than $10.00.

Increases for Capital Improvements

Amount of Increase	No. of Cases	Pct. of Cases
$0.01 - $9.99	1780	23%
$10.00 - $24.99	2169	27%
$25.00 - $49.99	1896	24%
$50.00 - $74.99	770	10%
$75.00 - $99.99	359	4%
$100.00 - $149.99	429	5%
$150.00 - $199.99	156	2%
$200.00 - $249.99	85	1%
$250.00 or more	247	3%
Total	7891	

c. Building Size and Distribution of Increases

The frequency of capital improvement increases has been significantly higher among larger buildings. For example, in buildings with one to four units, 12% of all units have obtained capital improvements increases. In buildings with 5 to 20 units the ratio is 27%. In buildings with more than 20 units the ratio is 37%.

Possible explanations for the differences in frequencies in increases among different size buildings may be: efficiencies of scale, greater sophistication of owners of larger properties, alternate investment strategies of smaller properties focusing on appreciation and conversion to other uses.

d. Rents of Units Obtaining Capital Improvement Increases

58% of the units which received capital improvements increases had higher rent ceilings than median for comparable size units in the same tract before the increases were obtained. Twenty percent of the units had rents that were more than $100 above the median.

Units Obtaining Capital Improvement Increases
Rent Levels Compared with Median Rents for the Census Tract
(Before Increase Granted)[135]

Below Median	Rent Level Difference from Median	Above Median
300 units	$0.00 - $9.99	334 units
472	$10.00 - $24.99	438
639	$25.00 - $49.99	712
532	$50.00 - $74.99	687
379	$75.00 - $99.99	454
401	$100.00 - $149.99	632
123	$150.00 - $199.99	293
45	$200.00 - $249.99	154
43	$250 or more	312
2934	Total	4016

[135] This sample does not include units for which bedroom data is missing.

e. The Type of Work Covered by Capital Improvements Increases

Categorization of capital improvements has not been standardized.[136] The following table lists the number of times a unit received a particular type of capital improvement increase for the most common categories listed by apartment owners in applications filed between 1993 and 1995. The data provide a rough guide to the types of work performed, but should not be seen as a source of precise ratios, due to the lack of a standardized cateogroization procedure.

Types of Capital Improvements (Partial List)
(From increase cases in 1993-1995)
(Total number of improvements listed - 12,256)

Category	Approximate Pct. of Improvements
Refrigerator	2.7%
Stove	1.5
Carpet	8.1
Electrical	6.7
Elevator	7.9
Foundation, Termite work	1.4
Linoleum/Tile	2.1
Painting (exterior or garage-8.7%)	18.3
Paving	1.1
Plumbing	1.8
Roof	6.3
Security	2.3
Water heater/boiler	4.3
Windows	1.5

f. Financing of Capital Improvements

In the past few years, over 90% of all capital improvements have been self-financed and therefore qualifying for the imputed interest rate of 10%.

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[136] Classifications were made by the applicants in the applications. Some were very specific while others were very general. The statistics in the table below constitute an aggregation of the classifications by this author.

3. Basic Issues in the Design of Capital Improvement Increase Standards

Capital improvements increase standards and the volume of capital improvements increases vary greatly under different rent control ordinances. Under some ordinances a substantial number of increases are obtained for capital improvements while under others few increases are obtained. Although capital improvement increase provisions are contained in all rent control ordinances, there is little understanding of the degree to which particular standards actually encourage capital improvements or alternatively only serve to provide increases for improvements which would have been performed anyway.

Consideration of capital improvements standards involves consideration of numerous issues and options. These include (but are not limited to):

- whether the ordinance also includes a vacancy decontrol provision

- whether capital improvements are considered independently or in conjunction with a fair return (net operating income) analysis;

- the definition of capital improvements

- are capital improvement increases temporary or permanent;

- the amortization period;

- interest allowances;

- annual ceilings on capital improvement increases (with phase-in of increases over the ceiling amounts)

- distinctions between "necessary" and "unnecessary" improvements

a. The Interelationship Between Capital Improvements Standards and Vacancy Decontrols

Under the Los Angeles, San Francisco, and San Jose ordinances, which contain vacancy decontrol provisions, no additional rent is allowed for capital improvement increases after a vacancy, if the increase was granted before the vacancy, "since the landlord has the opportunity

to bring the unit up to market rent at the time the unit is rerented."[137] San Francisco also does not permit capital improvement increases for "units rented within six months of the commencement of work."[138] San Jose does not permit capital improvement increases within 12 months after a tenant moves in.[139]

b. Consideration of Capital Improvement Costs in Relation to Overall Income

A basic issue in the design of capital improvement standards is whether to consider capital improvements independently or in conjunction with an overall fair return analysis. Inclusion of capital improvement expenditures in the net operating income formula has been typical of jurisdictions that have used MNOI approaches. The theory underlying this approach is that an apartment owner should not receive special increases for capital improvements if the rent increases are already adequate to cover operating cost increases, including the cost of the capital improvements, and permit adequate growth in net operating income.

While consideration of capital improvements costs within an overall analysis of net operating income has been common under rent regulations (although far from universal), one federal court has ruled that landlords have a constitutional right to fair profit on capital improvement increases independent of an NOI analysis.[140] This conclusion was based on the reasoning set forth in an earlier federal Court of Appeals decision, holding that "every dollar the landlord puts into the property by way of capital improvements constitutes an investment in the property for which a 'fair and reasonable' return must be allowed." Sierra Lake Reserve v. City of Rocklin.[141]

c. Definitions of capital improvements

Broad and narrow definitions of capital improvements have opposite impacts depending on whether capital improvement expenditures are considered in conjunction with a fair return analysis or independently. Under an MNOI formula, all expenses are considered either as operating expenses or capital improvements.

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[137] San Francisco Residential Rent Stabilization and Arbitration Board Rules and Regulations, Section 7.12(b) "Effect of Vacancy on Rent Increases Requested for Capital Improvements". Also see Los Angeles Rent Stabilization Division Regulation 212.04.

[138] Id.

[139] San Jose - Regulation 2.04.02.

[140] Hillsboro Properties v. City of Rohnert Park, _____ (1994).

[141] 938 F.2d. 951, 958 (1991).

If a particular type of work (e.g. painting) is not a considered as a capital improvement it is expensed within one year in the net operating income formula. Therefore, treatment of a particular type of expense as a capital improvement under an MNOI formula and expensing it over a number of years, reduces the amount of the rent increase allowed as a consequence of that expenditure.

Conversely, when capital improvements are treated independently of an MNOI analysis, broad definitions of capital improvements are likely to increase the rent increases associated with capital improvements. NOI only becomes an issue if an owner applies for an MNOI increase, as well as a capital improvements increase. However, increases based on MNOI are not likely to be justified if across-the-board increases are adequate to cover the increases mandated by the MNOI formula. Also, apartment owners prefer the simplicity of a making a petition that is limited to consideration of capital improvements expenses.

Rent ordinances contain varying definitions of capital improvements. Some contain broad definitions which include most types of work that costs more than a few hundred dollars and is not a minor repair. Other ordinances have tied capital improvements definitions to the definitions of "improvements" contained in the internal revenue code[142] - work which adds to the value of a property, prolong its useful life, or adapt it to new uses.

The IRS guidebook Residential Rental Property contains the following discussion:

> **Repairs and Improvements**
> You can deduct the cost of repairs that you make to your rental property. You cannot deduct the cost of improvements. You recover the cost of improvements by taking depreciation (explained later). ...
> **Repairs.** A repair keeps your property in good operating condition. It does not materially add to the value of your property or substantially prolong its life. Repainting your property inside or outside, fixing gutters or floors, fixing leaks, plastering, and replacing broken windows are examples of repairs.
> If you make repairs as part of exgtensive remodeling or restoration of your property, the whole job is an improvement.
> **Improvements.** An improvement adds to the life of the property, prolongs its useful life, or adapts it to new uses. Putting a recreation room in an unfinished basement, paneling a den, adding a bathroom or bedroom, ... putting up a fence, putting in new plumbing or wiring, putting in new cabinets, putting on a new roof, and paving a driveway are examples of capital improvements.[143]

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[142] E.g. San Jose Municipal Code Sec. 17.23.050.

[143] Internal Revenue Service Publication 527, p.3.

Other ordinances have excluded "replacements" from the definition of capital improvements.[144] A definition of this type is based on the theory that replacements are ordinary expenses to be expected in the operation and maintenance of rental housing. Therefore, their cost, even if they are expensive and long term in nature, was considered in setting the pre-rent control base rent. Under this theory, granting capital improvements increases for replacements would be "double counting" to the extent that the cost of replacements are already covered by the existing rent structure, and general adjustments include consideration of increases in average maintenance costs.

The Los Angeles and San Francisco regulations exclude interior painting from the definitions of capital improvements.[145] Under the San Francisco regulations "[if an] appliance is a replacement for which the tenant has already had the benefit, the cost will not be amortized as a capital improvement, but will be considered part of operating and maintenance expenses .... unless [it is] part of a remodeled kitchen."[146]

4. Capital Improvement Standards in Other Rent Controlled Jurisdictions

This section describes various aspects of capital improvement standards in other California jurisdictions that illustrate alternative types of approaches.

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[144] The rent ordinance makes a distinction between "capital improvements" and "ordinary, repair, replacement, and maintenance" (Section 12.c(3). It states that: "In making individual adjustments ... the Board ... shall consider ... (3) The cost of planned or completed capital improvements ... (as distinguished from ordinary repair, replacement and maintenance). But, there is no amplification on the meaning of these terms.

[145] See Los Angeles Rent Stabilization Division Regulation 211.01 and San Francisco Rent Board Regulations Sec. 7.12(c) (Schedule I).

[146] Id.

a. Los Angeles

In Los Angeles, capital improvements standards[147] have been the subject of considerable controversy.[148] For ten years, the regulations provided that capital improvement increases, were permanent additions to the base rent, with the annual increase equal to one-fifth of the cost of the improvement. These costs were considered independently, without any consideration of net operating income. No allowance was made for interest.

The volume of increases was substantial, notwithstanding the facts that the law included a vacancy decontrol provision and that annual across-the-board increases were seven percent up to that time. From 1985 through 1989, between 20,000 and 30,000 units a year were granted capital improvements increases,[149] (out of a total of approximately 500,000 units under rent stabilization).[150]

In 1988 and 1989, in response to criticisms of the excessive level of capital improvements increases, the standards were reviewed by staff.

In 1989, the following revisions were made to the capital improvements standard.

- Increases were made temporary (6 years), instead of permanent

- Increases were no longer added to base rent

- Only 50% of the cost of a capital improvement would be allowed

Since then, the number of capital improvement increases has been drastically reduced.[151]

Under the L.A. standard, capital improvement increases are limited to $55 per month. If the an increase exceeds $55, the time period of the capital improvement increase is lengthened so that the additional amount of the increase can be recovered.

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[147] L.A. Rent Stabilization Regulations Sections 210-219.

[148] For discussion of the capital improvements standards and data on increases under these standards see Hamilton, Rabinovitz, and Alschuler, 1994 Rental Housing Study, Technical Report on Issues and Policy Options, Section V.G. ("Reinvestment in Rent Stabilized Properties: The Role of Cost Allowances for Building and Dwelling Unit Improvements"), pp. 309-332 (Los Angeles Housing Dept., Rent Stabilization Division).

[149] Supra note 148 at 324 (Chart 116).

[150] Id. at p.6 (Chart 1).

[151] In 1992, increases were granted for 2,910 units. Since then data has not been compiled on the level of capital improvement increases; however, staff members have indicated that the number has further declined.

Petitions for increases must be made within one year of the completion of the improvement. Increases for exterior painting are limited to once every ten years.

Los Angeles also had a substantial renovation program under which permanent removal from rent control was authorized when owners made renovation investments in excess of designated amounts, ranging from $10,000 to $17,000 per unit. "Substantial" renovation work was never defined.

In 1989, the program was rescinded after a survey of the substantial renovation cases concluded that the mechanism was primarily used "as a method of gentrification without achieveing the goals for major reinvestment or neighborhood stabilization". The results of that program illustrate how such a policy may not produce the intended results.

> The Department's review of the substantial renovation exemption process has shown that the nature, location, and extent of participation in the substantial renovation process indicates that it has been utilized as a method of gentrification without achieveing the goals for major reinvestment or neighborhood stabilization. Owners are making the types of improvements to units that will attract tenants able and willing to pay higher rents. This has resulted in the displacement of those tenants unable to afford those rents. In some applications that have been approved by this Department, tenants who have appealed have testified that the owner renovated units in "good condition" which were already demanding above-average rents. ...
>
> A recent survey of over 500 applications submitted from [1982 through 1988] ... revealed the following:
>
> A majority of the applications submitted were for properties located in areas of the City experiencing gentrification (e.g. portions of West Los Angeles, Wilshire Corridor, San Fernando Valley).
>
> The units were in acceptable condition, able to demand adeqate rents and occupied in general by the types of tenants who are the intended beneficiaries of the RSO: low and moderate income individuals and families, the elderly and those on fixed income.
>
> The types of improvements, although costly, were mostly incidental and related to appearances -carpeting, cabinets, drapes, painting - which are not permanent or structural changes and did not fulfill the "new construction" intent.[152]

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[152] Memo from General Manager to Councilman Michael Woo, Goverment Operations Committee, "Substantial Renovation Exemption Provisions of the Rent Stabilization Ordinance", July 22, 1988, p.2.

b. **San Francisco**[153]

In San Francisco, all improvements are amortized over a seven or ten year period. The imputed interest rate for self-financed improvements is tied to the rate for seven years treasury notes (presently 7.6%). There is a ten percent or $30 ceiling, whichever is greater on capital improvement increases; when larger increases are justified they must be deferred.

c. **Santa Monica**[154]

In Santa Monica, capital improvement expenses are considered in conjunction with a fair return analysis under an MNOI standard. The volume of NOI increases has been low.

In recent years, substantial amendments have been made to the fair return standard. In response to issues related to the difficulty of tracking and implementing downward rent adjustments upon the termination of improvements, capital improvement increases were made permanent. However, in order to offset the benefits of making the increase allowances permanent, interest allowances were eliminated. But, at the same time, the former amortization schedules have been retained. Therefore, the amount of overall rent increases for individual capital improvements that cost equal amounts vary enormously according to their amortization schedule.[155]

d. **West Hollywood**

In West Hollywood, consideration of capital improvements is incorporated into a fair net operating income analysis. From the adoption of the ordinance in 1985 to the present, MNOI increases have been obtained for 406 units out of a rent controlled stock of 16,000.

The following tables summarizes some of the principal provisions of the capital improvements standards of Berkeley, Los Angeles, San Francisco, Santa Monica, and West Hollywood.

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[153] San Francisco's capital improvement provisions are set forth in Rent Board Rules and Regulations Section Sections 7.10 - 7.18.

[154] This analysis does not take into account Santa Monica's special program for earthquake related repairs.

[155] For example, if a $1,000 increase is amortized under a five year schedule the permanent monthly increase is $16.66. If it is amortized over ten years, the permanent monthly increase is $8.33.

CAPITAL IMPROVEMENTS STANDARDS UNDER RENT CONTROL LAWS

Jurisdiction	Expense Treated Separate from Fair Return	Life of Improvements	Interest Allowance	Ceiling on Increases	Life of Increase
Berkeley	Yes	5-10 yrs.	Actual or 10% imputed	15% or $53	Life of Improvement
Los Angeles	Yes only 1/2 of expense allowed	6 yrs.	None	$55	6 years
San Francisco	Yes	7-10 yrs.	Actual or 7.7% imputed (10% ceiling)	$30	7-10 years
Santa Monica	No	5-20 yrs.	None	none unless tenant hardship	permanent
West Hollywood	No	4-10 yrs.	Actual or 5.5% imputed	12% inc. a.g.a.	4-10 yrs.

RENT INCREASES UNDER ALTERNATE CAPITAL IMPROVEMENT STANDARDS
(Cost $1,000, Life 10 years)

Jurisdiction	Monthly Increase	Time Period	Total Increase (inc. interest allowance)
Berkeley	$13.00	10 years	$1588.81
Los Angeles	$8.33	6 years	$599.76
San Francisco	$15.39	10 years	$1433.60
Santa Monica	$8.33	permanent must be justified under MNOI analysis	
West Hollywood	$10.85	10 years must be justified under MNOI analysis	$1302.00

h. The Volume of Capital Improvements Increases - Berkeley Compared with Other Jurisdictions

Comparison of the volume of capital improvements increases among different jurisdictions is subject to the limitations of available data. For example, cities other than Berkeley only have data on the total number of increases granted, without data on the number of total number of units that have received an increase at any time. Some cities only have data on the number of petitions filed, rather than the number of increases granted.

In Berkeley, as previously indicated, 7,891 increases[156] have been obtained for a stock of approximately 19,751 units. These increases have been obtained by 4,945 units. The average increase per case has been $50. The average overall increase obtained by each of the 4,945 units receiving increases has been $79, taking into account units that have received more than one increase.

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[156] As previously indicated, this figure does not take into account all of the increases granted prior to 1987.

In Los Angeles, as of 1992, 146,906 increases had been obtained for a stock under rent stabilization of approximately 500,000 units.[157] The data does not indicate how many units were covered by these increases. The average increase has been $16. Staff has indicated that the volume of applications has been low since 1992.[158]

San Francisco compiles data on the number of capital improvement petitions, but not on the number granted and the amounts of the increases. Through FY 93-94 capital improvement petitions had been filed for cases involving 23,819 units[159] compared to a rent controlled stock of about 250,000 units.[160]

In West Hollywoood and Santa Monica, which incorporate consideration of capital improvements into the NOI analysis, no data has been compiled on capital improvement increases. However, the volume of MNOI petitions has been small, involving less than 10% of all units.

It would not seem that the high volume of petitions in Berkeley can be attributed to the fact that its rent restrictions were more stringent than those of other cities, since the highest rates of increases have occurred in the past few years. As the data from the other cities illustrates, the volume of capital improvements increases is a function of whether capital improvements are considered as an expense within an MNOI analysis and the size of the increases permitted under the capital improvement standard. Los Angeles had a higher level of petitions at the same time that it annual general adjustment provisions were more liberal.

5. Discussion and Comment

As the section on the design of capital improvement standards illustrates, a wide range of policy options is available, subject to substantial uncertainties about the future scope of case law restrictions on the range of permissable actions. Until the two recent federal court cases, judicial precedent specifically about capital improvement standards was virtually non-existent and judicial fair return analysis considered overall returns. As far as this author is aware, none of the jurisdictions with apartment rent control ordinanes have modified their capital improvements regulations as a result of the two recent federal decisions.

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[157] H.R.& A. supra note 148 at 324 (Chart 116).

[158] Increases were granted for 2,910 units in 1992.

[159] San Francisco Rent Board, "Annual Summary of All Petitions, Table 1.

[160] This estimate does not take into account units which came under the ordinance in 1982.

The data on types of capital improvements for which increases were obtained under the Berkeley ordinance indicates that they are mainly for replacements and maintenance, which are required to operate rental units, rather than "new" services or "additions".

Without a survey of maintenance levels it is not known whether capital improvement increases are actually connected with higher levels of maintenance. Alternatively they may be primarily a function of the apartment owners' desire and ability to participate in the individual rent adjustment process and/or a function of whether the capital improvements increases can be recouped because the rents are below market levels. The fact that the rate of capital improvement petitions increases is correlated to building size must either indicate that larger buildings have better maintenance or alternatively that owners of larger buildings are more likely to obtain increases for the same levels of maintenance.

From a policy perspective there are significant justifications for tying rent increases for replacements and ordinary maintenance to an MNOI analysis. These expenditures are a part of the overall operation of rental properties and should be viewed in this context. In essence capital improvement increases may be rent increases rewarded for providing the same maintenance that was provided before rent control was adopted. The effect of segregating replacement and maintenance costs in excess of $200 and allowing separate increases for them may be to increase NOI levels at a greater rate than authorized by the MNOI standard. Such segregation of expense types is not consistent with the overall intent of the MNOI approach, to permit fair rates of growth in NOI. Granting capital improvements increases for ordinary replacements can be viewed as a form of "double counting" to the extent that increases in these expenditures are already covered by the annual general adjustments.

The policy justification for allowing capital improvements increases without considering overall income and expenses is that owners may not be willing to go through the MNOI application process because it is much more complicated than a passthrough system. Therefore, there will be less of an incentive for owners to make expenditures for apartment maintenance and improvements.

As a practical matter, as long as capital improvement expenditures (expenditures of over $200) are considered separately from other types of expenditures (expenditures costing less than $200) there are strong incentives to shift expenditures from the under $200 category to the over $200 category.

Policy Options

As the description of policies in other jurisdictions illustrates, policy options in regards to capital improvements are nearly infinite. Starting points for the consideration of capital improvements issues may include:

- Evaluation of issues that did not exist previously regarding the interrelationships between capital improvements increases and vacancy decontrol increases,

- Review of general issues related to the design of the capital improvements standard,

- Consideration of other possibilities, which have not been instituted in other jurisdictions, include differing capital improvement procedures for different types of improvements and for buildings which have differing rent levels relative to the medians for comparable units.

- Review of the timing of capital improvement increases relative to their actual life and their date of completion and possible differences that may occur between which tenants who benefit from the improvement and which tenants pay for the improvement

In any case, it is critical to understand that capital improvement issues should be considered as a package.

B. Passthroughs of Property Tax Increases Triggered by Sales

1. Berkeley's Standard

Since 1990, apartment owners have been able to obtain a rent increase to cover property tax increases triggered by the purchase of a property that has occurred at any time since the base year (Regulation 1279)

2. The Practical Operation of the Standard

In California, pursuant to Proposition 13, increases in assessed value are limited to 2% per year except when a property is sold, at which time it is reassessed at market value. Properties which have not sold since 1978 are assessed at 1975 values adjusted by 2% per year since 1978. The property tax rate, which is limited by Proposition 13 to one percent plus voter approved increases, is now 1.125%.

As a result of the limitations on assessment increases when there are no changes in ownership, property taxes may increase substantially when a property is sold. Each $1,000 increase in value results in a property tax increase of approximately $1.125 per month. For example, a rental unit which was purchased for $15,000 in the 1970's, might have had an assessed value of approximately $20,000 in 1995 before it was sold and an assessed value of $45,000 after it was sold. As a result of the $25,000 increase in assessed value, the annual property taxes on the unit would increase by approximately $26 per month.[161]

In the case of units purchased near the end of the 1970's or later at higher prices, the property tax increase triggered by a sale may be smaller. For example, the assessed value of unit purchased in 1980 for $30,000 would be approximately $36,000 in 1990. If it were then purchased for $45,000 in 1990, the increase in assessed value of $9,000 would trigger a property tax increase of $9.33 per month. Alternatively, a much higher property tax increase (e.g. $30 to $60 per month) may occur if a unit were purchased in the 1970's for a relatively low price and sold in the 1990's for well over the average price.

3. The Amount and Volume of Property Tax Passthrough Increases (1990 - June 1995)

A total of 1,614 units have received increases for property tax increases triggered by purchases. The average rent increase for property tax passthroughs has been $19.46. Eighty five percent of the increase have been less than $30; twenty-three percent have been less than $10. Purchasers of smaller buildings have been much less likely to obtain this type of increase. Only 236 (16%)

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[161] ($25,000 increase) x .0125 : 12 = $26.04.

of the tax passthroughs were for units in buildings with less than five units, compared to their 30% share of the stock.

4. Potential Property Tax Passthroughs

The total of 1,614 property tax increase passthroughs compares with a total of approximately 10,000 units which have changed ownership since the base year.[161] However, a significant portion of the 10,000 units, principally units that were acquired in the 1980's from owners who had purchased them in the late 1970's or 1980's, might not have experienced significant increases in assessed value (e.g. the assessed value might have increased from $25,000 to $30,000). In the 1990's, approximately 4,700 units have been purchased. Based on trends in apartment values in the last four years, it is clear that a significant portion of these units experienced substantial increases in assessed value.

4. Policies of Other Jurisdictions in Regards to Property Tax Increases

As far as this author is aware, no other rent control regulations in California provide for the type of property tax passthrough provision that Berkeley has. In other jurisdictions, property tax increases are considered along with other cost increases within a fair return application.

5. Discussion and Comment

Rationale for providing a separate process for recouping property tax increases may be that: 1) the increase is unavoidable, 2) it may be substantial, 3) it is easily calculated, 4) it cannot be decreased[162] (in contrast to other types of costs, such as maintenance), 5) it cannot be addressed through the general adjustment process because the increases vary greatly among properties. The property tax increase passthrough may be seen as a type of special adjustment to compensate for cost increases not covered by the calculations of operating expenses contained in the annual general adjustment report.

The criticism of an independent passthrough of this type of cost increase is that it may result in increases to owners who are already realizing a rate of growth in net operating income in excess of that mandated by the indexing ratio in the MNOI standard. Another criticism is that the cost increase is tied to appreciation in property values, rather than increased expenditures for the benefit of the tenant; therefore, it should not be passed through to the tenant except when needed to provide a fair return.

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[161] See Table on p.10.

[162] In theory property taxes may decrease through the tax appeal process, based on a reduction in the value of the property.

C. Adjustments of "Historically Low Rents" (HLR)

1. Berkeley's HLR Standard and Its Background

Under Berkeley's HLR standard, which was took effect in 1991, units whose base rents were below 75% of the HUD fair market rent for comparably sized units became entitled to have their 1991 rents adjusted to equal 1979 HUD Fair Market rents adjusted by the subsequent annual general adjustments. (Regulation 1280 sets forth the ceilings on eligibility for the increases and the levels to which the rents may be increased.)

This standard was subject to lengthy and detailed consideration for several years before it was adopted. Its adoption was based on the view that regulations designed to curb excessive rents and excessive rent increases work unfairly against owners who were charging relativedly low rents when the rent control ordinance was adopted. This group of owners, besides having the lowest base rents, obtained the lowest dollar rent increases under the across-the-board increases that were calculated on a percentage basis.

2. Data on HLR Increases

Overall 1,646 units (8.3% of all units) have been granted HLR increases. The ratio of HLR increases has been highest among buildings with between 5 and 10 units. 13% of all units in this class have obtained increases. In contrast, 5.2% of the units in one to four units buildings have obtained HLR increases. The rate of HLR increases has been lowest among buildings with 26 or more units. 4% of the units in this group have obtained increases.

The lower rate of increases among larger buildings (as opposed to the pattern for capital improvements increases) may be an outcome of differences between small and larger building operators before the adoption of the rent control ordinance. The owners of larger buildings may have been more likely to be "profit maximizers" prior to regulation.

Within the class of units eligible for HLR increases, participation rates were significantly lower among owners of smaller buildings. (See table below)

Proportion of Eligible Units Receiving Increases

Size of Bldg.	Pct. of Eligible Units Receiving Increases
1-4 units	27%
5-10 units	40%
11-15 units	48%
16-20 units	53%
21-25 units	64%
25+ units	33%
All units	39%

From a geographical perspective, the census tracts with the highest HLR rent adjustment ratios, about 16% of the rent controlled units in the tracts, were in the corridor between Martin Luther King Jr. Way and Sacramento Ave, north of Ashby and south of Cedar. The highest ratio, 20%, was in the tract north of Cedar between Sacramento and San Pablo.

61% of the HLR increases were granted in 1992. It would make sense that the bulk of HLR increases would be granted shortly after the regulation was adopted since there was no benefit to delay in obtaining the increases and additional units do not become eligible for this type of increase over time.

3. Potential for Additional HLR Increases

A comparison of legal rent levels with minimum rent levels under the HLR standard[163] indicates that another 2,627 units, 13% of all units, may be eligible for HLR increases.[164] The range of potential increases is set forth in the following chart:

Potential HLR Increases

No. of units	Size of Increase
390	$0 - $ 9.99
345	$10 - $19.99
262	$20 - $29.99
265	$30 - $39.99
202	$40 - $49.99
770	$50 - $99.99
278	$100 - $149.99
78	$150 - $199.99
37	$200 or more

The census tracts with the highest ratio of potential HLR increases, over 25% of the units in each tract, are all located west of Sacramento Ave.

Various explanations may be offered as to why HLR increases have not been obtained for 61% of the units that may be entitled to such adjustments.

- Some owners do not want to make the effort to petition for small increases

- Some owners might have been satisfied with the Searle increase which took effect at about the same time the HLR adjustment program was instituted and/or felt that tenants would have severely resisted additional increases at a time when legal rent levels were raised 28%

- Because, the minimum rent levels for HLR units were set on a city-wide basis, they were significantly higher than 75% of median rents in lower rent areas of the city. Therefore, the increases might not have been perceived as reasonable by tenants and landlords of units in those areas.

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[163] These levels are set forth in the table at the end of Regulation 1280.

[164] This calculation excludes units which rents below HLR adjustment minimums, but are not eligible for HLR increases. The estimate is based on a count of eligible units adjusted by the percentage of units for which bedroom size information is missing.

- Many owners do not want to go through an individual rent adjustment process.

- Some owners are not aware of the program

4. Judicial Precedent Regarding Adjustments of "Low" Rents

The question of whether owners have a constitutional right to additional rent adjustments for low rents was first addressed in Vega v. City of West Hollywood.[165] The facts in that case were exceptional. In 1983, the rents ranged from $70 to $180 per month. The rents of several units had not been raised in 15 to 20 years. The 84 year owner had constructed the units 40 years earlier.

In the Vega case, the Court guided by the State Supreme Court's holding in Birkenfeld v. City of Berkeley, declared that:

> Rent ceilings of an indefinite duration would be confiscatory and thus unconstitutional if no adjustment mechanism existed ... for "situations in which the base rent cannot reasonably be deemed to reflect general market conditions." [citing Birkenfeld v. City of Berkeley].[166]

The Court held that "a property owner must be permitted, pursuant to the principles discussed in Birkenfeld v. City of Berkeley [cites omitted], to start rent calculations with a base rent similar to other comparable properties.[167]

Subsequently, in Apartment Association of Greater Los Angeles v. Santa Monica Rent Control Board, the Court of Appeal[168] rejected the view that owners had a general entitlement to adjust below market rents. It ruled that:

> Respondents' position that "Birkenfeld and Vega establish a constitutional standard of general application to all historically low rent properties without exception" is not supported by the opinions in those cases, and we hold that there is no general entitlement to an increase in base date rents predicated on market conditions.[169]

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[165] 223 Cal.App.3d.1342; 273 Cal.R.243 (1990).

[166] Id, 223 Cal.App.3d. at 1349; 273 Cal.Rptr. at 247.

[167] Id, 273 Cal. App.3d. at 1352; 273 Cal.Rptr. at 249.

[168] The panel that authored the opinion contained one of the three judges who had authored the Vega opinion.

[169] 24 Cal.App.4th 1730,1737; ___ Cal.Rptr.2d. ___,___ (1994).

The Court distinguished Birkenfeld and Vega on the basis that "in both cases the entitlement to an increase in the base rent depended on the existence of circumstances that prevented the base rent from reflecting market conditions."[170] The Court noted that in Birkenfeld, the State Supreme Court found that the failure to include any provision for adjustment of base rent was unconstitutional and suggested that conditions for a base rent increase included "seasonal fluctuation in demand [or] a special relationship between the landlord and tenant."[171]

In City of Berkeley v. Berkeley Rent Stabilization Board, the Court of Appeal ruled that the Board had the authority to adopt the Historically Low Rent Regulation.[172] It also overturned the trial court's ruling that Berkeley's HLR regulation could not apply to post rent control purchasers.

4. Treatment of Historically Low Rents by Other Jurisdictions

Historically low rents have been an issue in Berkeley and Santa Monica, the prinicipal jurisdictions without vacancy decontrol provisions.

i. Santa Monica

In December 1991, Santa Monica adopted a "threshold rent increase" provision.[173] It provides for rent increases upon vacancies up to median levels for rent controlled units with the same number of bedrooms in the same zone of the city. Since the regulation was adopted approximately 15% of the units in the city have obtained increases pursuant the standard. The average increase has been approximately $100.

ii. West Hollywood

West Hollywood, which has permitted 10% increases upon vacancies, authorizes adjustments of rent that was "disproportionately low [on the base date] due to the fact it was not established in an arms-length transaction or other peculiar circumstances."[174] The increase cannot be

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[170] Id., 24 Cal.App.4th at 1737-1737.

[171] Id.

[172] 27 Cal.App.4th 951, 983-984; 33 Cal.Rptr.2d.317,337-338 (1994).

[173] Rent Board, Regulation 3300.

[174] West Hollywood Municipal Code, Sec. 6411.c.1.(g)(2).

obtained by post-rent control purchasers. Additionally, in order to establish "peculiar circumstances" the petitioner must demonstrate one of the following: (1) a close family or friend relationship with the tenant, (2) the rent had not been increased for five years prior to the adoption of the ordinance, (3) the tenant performed services for the owner, (4) there was low maintenance of the property in return for low rent increases or no rent increases, or (5) other special circumstances outside of market factors.

iii. San Francisco

In its comparable section, San Francisco authorizes petitions "based on extraordinary circumstances" in order to raise rents to levels of "comparable" units.[175] The circumstances include but are not limited to:

> where because of a special relationship between the landlord and tenant or through fraud, mental incompetency, or some other reason, the initial rent on a unit was set very low or the rent was increased only negligible amounts during the tenancy.

When an increase is granted pursuant to the "comparable" section, the owner is precluded from any banked or operating and maintenance increases that could have been imposed prior to the filing of the petition.[176] Few increases have been granted pursuant to San Francisco's "comparable" standard.[177]

5. Discussion and Comment

Adjustment of historically low rents has always brought into play the tensions between the competing goals of stabilizing rents and permitting substantial rent increases to bring low rent units up to "fair" rent levels.

Santa Monica moderated the impact of its counterpart to Berkeley's HLR program by limiting the increases to units which became vacant. West Hollywood has continually allowed limited increases upon vacancies.

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[175] Rent Board Rules and Regulations, Section 6.11 (a).

[176] Id, Section 6.11(a)(2).

[177] Source: Staff Interview. A greater number of "comparable" increases have been granted to units in smaller buildings which were exempt from rent controls until 1992. The "comparable" standards for these units vary from those applicable to units that have been rent controlled since the early 1980's.

Critics of HLR adjustments have taken the position that such increases provide windfalls for post rent control purchasers who paid lower prices as a consequence of the low rents. The trial court took this position in the Searle case. This author has consistently criticized linkages between rent adjustments and ownership characteristics or the particular purchase price paid by an owner or the purchase date of the property.

The current HLR standard offers the advantage of simplicity, for applicants and the Board, by basing rent adjustments solely on the number of bedrooms and the HUD median rent schedule, rather than more subjective criteria such a rents for comparable units based on appraisal criteria. Therefore, only minimal effort is required to prepare an application for an increase under the standard and process the application.[178] On the other hand, the simplicity operates counter to "general market conditions" governing rents which reflect factors such as the quality and size of a unit (as opposed to a mere count of the number of bedrooms) and the attractiveness of its particular location. Such factors typically played a role in the setting of pre-rent control rents and the purchase prices paid for the units.

Review of the HLR standard may include consideration of:

- Establishment of an HLR rent adjustment schedule by district. The concept of a uniform schedule for the whole city may avert the difficulties associated with establishing distinctions and boundaries. However, it creates rent standards that do not comport with "market conditions" in an even manner. Citywide standards may raise some rents to 60% of the "market" median while raising other rents over "market" medians. On the other hand, it should be understood that a "district" approach for establishing rent adjustment standards may increase allowable standards in some areas, as well as reducing them in others.

- Not permitting HLR increases in cases where owners have obtained vacancy increases. The purpose of the vacancy increases, like HLR adjustments, is to permit rent adjustments for market conditions.

- Adopting the Santa Monica approach of only permitting HLR type increases upon vacancies and thereby avoiding hardship for sitting tenants. Such an approach could permit the HLR increase as an addition to the vacancy increase. Alternatively, it could limit the HLR increase to amounts not covered by the vacancy increase.

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[178] Issues may arise over the question of the number of bedrooms in a unit.

APPENDIX A

Consideration of Owner's Individual Financing Arrangements

At various times suggestions have been made that in cases where indexing is at less than 100% of the rate of increase in the CPI, 100% indexing should be permitted for landlords who own their properties free and clear. Under less than 100% indexing, owners without mortgages will realize a slower rate of growth in NOI relative to their equity than owners with mortgages. However, in absolute dollar terms they will realize the same growth in NOI.

Typically owners without mortgages have owned their properties for a substantial number of years. In the case of Berkeley, longterm owners (20 years or more) with typically leveraging ratios at the time of purchase have benefitted from more than 600% appreciation in their equities (e.g. from $5,000 to $35,000 per unit between 1973 and 1995. See "Average Apartment Values" table on p.11 and "Appreciation ..." table on p.38.) In comparison, the CPI increased by approximately 200% during the same period.

While making individual adjustments depend on individual financing arrangements may address some concerns, such an approach would lead to a host of legal and "equity" problems. A major strength of the NOI formula is that growth in NOI cannot be manipulated by individual financing arrangements. If individual debt service ratios were a determinant of indexing ratios for individual owners, rent increases could be obtained simply by reducing mortgage principle. Subsequently, after a rent increase was obtained on this ground, an owner could increase the debt service ratio. See "Guidelines for Drafting Rent Control Laws: Lessons of a Decade", 35 Rutgers Law Review 721, 781-816 (1983) for comments on fair return formulas that consider financing arrangements of individual properties.

In several instances, courts have been highly critical of fair return standards which take into account individual financing arrangements. Generally, such issues have emerged in cases where owners have argued that they should obtain additional rent increases because they have substantial mortgage payments. In Helmsley v. Borough of Fort Lee (1978), the New Jersey Supreme Court commented on a fair return standard which considered mortgage payments.

> ... we have serious reservations about the constitutionality of the Rent Leveling Board's method of computing just and reasonable return. The Board purports to allow a specified rate of return upon the landlord's net investment after payment of reasonable operating expenses and debt service. ... the permitted rate of return was equal to one percent plus the mortgage constant on the applicant's first mortgage. [fn. omitted] Reliance on the terms of the applicant's mortgage, rather than current financing terms, leads to inequitable results. For example, the Board ruled on two hardship applications in January, 1978, applying rates of return of 7.4% and 10.05% based upon the applicants'

mortgage constants. Had both been allowed a 10% return, the first applicant would have received an additional $16,200. ...

The court concluded that:

> Similarly circumstanced landlords, ... must be treated alike. Discrimination based upon the age of mortgages serves no legitimate purpose.[1]

Similar comments are contained in a recent opinion of the California Court of Appeals.

> Palomar also complains that the City's formula refuses to treat interest expense on the debt incurred to purchase the parks as legitimate. This argument ignores the fact that the City's approach treats the total purchase price of the asset as the park owner's 'investment' rather than merely the amount of cash invested. Where the calculation of the park owner's return is based on the cost of the asset - normally a much larger figure - it makes no sense to deduct interest incurred to purchase the asset as an expense.
>
> Moreover, Palomar's version of the 'historic cost' formula means that an owner's fair return will vary depending on the financing arrangement. Assume to 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.[2]

In 1976, the Supreme Judicial Court of Massachusetts upheld the application of Brookline's net operating income formula which did not consider the large mortgage payments of a recent purchaser. Furthermore, the court noted that there were sound practical reasons for not taking financing arragements into account.

> The trial judge made his finding of confiscation "in light of the large interest factor with which [the plaintiff] is faced and which has in no degree been considered as a cost factor by the Board in determining the fair net operating

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[1] 394 A.2d. 65,80-81 (1978).

[2] Palomar Mobilehome Park Ass'n v. Mobile Home Rent Review Commission [of San Marcos], 16 Cal.App.4th 481, 488; 20 Cal.Rptr.2nd.371, 374-375 (1993).

income in this case." This approach was erroneous. Under c.842 a rent control board is not bound to consider the landlord's financing arrangements in setting rates, and there are sound practical reasons consistent with the intent of that chapter which support the board's policy. The rationale is particularly evident on the facts of this case, where the landlord has chosen to finance 100% of the cost of the building.[fn. omitted].

The plaintiff's debt service charges clearly would be less if he had undertaken "conservative" financing, which the trial court found to be 70% of fair market value. They would be even less had he chosen to give a more substantial downpayment of his own funds. The plaintiff's use of 100% financing, whatever the motoivation, was fundamentally a business decision within his discretion. Given the express concern of St.1970,c.842,Sec.1, with the "substantial and increasing shortage of rental housing accomodations for families of low and moderate income and abnormally high rents," a landlord's decision to minimize or wholly eliminate his initial capital outlay cannot justify imposing higher rents on his tenants. Nor does it warrant permitting him to collect higher rents than other less heavily financed landlords.[3]

Awarding greater rent increases to apartment owners with low financing costs would suffer from the same conceptual shortcomings that are associated with granting greater increases to owners with larger mortgages. The process would become subject to manipulation and would reward greater profits to one set of owners based on their individual financing arrangements.

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[3] Zussman v. Rent Control Board of Brookline, 359 N.E.2d.29 (1976, Supreme Judicial Court of Massachusetts).

Appendix B - CPI charts (U.S. Bureau of Labor Statistics)

All Urban Consumers - (CPI-U)

U.S. City Average

Rent, residential

(1967=100)

YEAR	JAN.	FEB.	MAR.	APR.	MAY	JUNE	JULY	AUG.	SEP.	OCT.	NOV.	DEC.	AVG.
1913													49.6
1914												49.6	49.6
1915												50.3	49.9
1916												50.6	50.5
1917												49.6	50.1
1918												52.1	51.0
1919						54.3						58.9	55.2
1920						64.0						70.6	64.9
1921					74.8				75.3			76.5	74.5
1922			76.2			76.6			76.8			77.2	76.7
1923			77.7			78.5			79.2			80.6	78.6
1924			80.8			81.7			81.8			81.9	81.5
1925						81.8						81.7	81.8
1926						81.0						80.6	81.0
1927						79.8						78.9	79.7
1928						77.8						77.0	77.8
1929						76.0						75.2	76.0
1930						74.1						72.6	73.9
1931						70.4						67.6	70.0
1932						63.3						58.5	62.8
1933						53.7						51.5	54.1
1934						50.5					50.4		50.7
1935			50.4				50.6			50.9			50.6
1936	51.2			51.3			51.9		52.1			52.8	51.9
1937			53.1			54.3			54.9			55.7	54.2
1938			55.9			56.0			56.0			56.0	56.0
1939			56.0			56.0			56.1			56.1	56.0
1940			56.1			56.2			56.3	56.3	56.3	56.3	56.2
1941	56.4	56.5	56.6	56.7	56.9	56.9	57.0	57.2	57.6	57.9	58.0	58.3	57.2
1942	58.4	58.5	58.7	58.8	59.2	58.5	58.3	58.3	58.3	58.3	58.3	58.3	58.5
1943	58.3	58.4	58.4	58.4	58.4	58.4	58.5	58.5	58.5	58.5	58.5	58.5	58.5
1944	58.5	58.5	58.5	58.5	58.5	58.5	58.6	58.6	58.7			58.7	58.6
1945			58.8			58.8			58.8			58.9	58.8
1946			59.0			59.1		59.2	59.3				59.2
1947	59.6	59.6	59.7	59.8	59.9	59.9	60.4	61.1	62.5	63.3	63.4	63.6	61.1
1948	64.0	64.1	64.2	64.3	64.7	64.9	65.1	65.4	65.8	66.1	66.2	66.6	65.1

U.S. Department of Labor
Bureau of Labor Statistics
Washington, D.C. 20212

3/4/85

Consumer Price Index

All Urban Consumers - (CPI-U)

U.S. City Average

Rent, residential

(1967=100)

YEAR	JAN.	FEB.	MAR.	APR.	MAY	JUNE	JULY	AUG.	SEP.	OCT.	NOV.	DEC.	AVG.
1949	66.8	67.1	67.3	67.4	67.6	67.8	68.0	68.1	68.4	68.7	69.0	69.2	68.0
1950	69.6	69.7	69.8	69.9	70.2	70.4	70.6	70.7	70.8	70.9	71.2	71.4	70.4
1951	71.5	72.0	72.4	72.6	72.8	73.0	73.2	73.5	73.9	74.3	74.6	74.8	73.2
1952	75.1	75.4	75.5	75.6	76.0	76.1	76.2	76.5	76.5	76.9	77.3	78.1	76.2
1953	78.4	78.6	78.7	79.0	79.6	79.8	80.1	81.0	81.5	82.0	82.4	82.6	80.3
1954	82.7	82.7	82.8	82.9	83.0	83.0	83.2	83.2	83.4	83.5	83.6	83.7	83.2
1955	83.8	83.9	84.1	84.1	84.3	84.3	84.3	84.4	84.4	84.6	84.7	84.8	84.3
1956	85.1	85.1	85.1	85.2	85.5	85.8	86.2	86.2	86.3	86.3	86.6	86.8	85.9
1957	86.8	86.8	86.9	87.0	87.2	87.4	87.5	87.6	87.8	88.0	88.2	88.4	87.5
1958	88.5	88.6	88.7	88.9	89.0	89.1	89.1	89.3	89.4	89.5	89.6	89.8	89.1
1959	89.8	89.9	90.0	90.1	90.1	90.3	90.3	90.5	90.6	90.8	90.9	91.1	90.4
1960	91.2	91.2	91.4	91.5	91.5	91.6	91.7	91.8	91.9	92.2	92.3	92.4	91.7
1961	92.4	92.6	92.6	92.7	92.8	92.9	92.9	92.9	93.1	93.2	93.3	93.6	92.9
1962	93.5	93.5	93.7	93.8	93.9	94.0	94.0	94.1	94.2	94.4	94.5	94.5	94.0
1963	94.6	94.7	94.7	94.8	94.8	94.9	94.9	95.0	95.2	95.3	95.4	95.5	95.0
1964	95.5	95.6	95.6	95.8	95.8	95.9	95.9	96.0	96.0	96.3	96.6	96.4	95.9
1965	96.4	96.5	96.7	96.8	96.8	96.8	96.9	97.0	97.1	97.2	97.2	97.4	96.9
1966	97.6	97.7	97.8	98.0	98.0	98.0	98.1	98.4	98.5	98.8	98.9	99.0	98.2
1967	99.1	99.4	99.5	99.6	99.7	99.8	100.0	100.2	100.4	100.5	100.7	101.0	100.0
1968	101.2	101.3	101.6	101.8	102.0	102.2	102.4	102.7	102.9	103.2	103.5	103.8	102.4
1969	104.0	104.3	104.5	104.8	105.1	105.4	105.7	106.1	106.5	106.9	107.2	107.7	105.7
1970	107.9	108.4	108.8	109.1	109.4	109.8	110.1	110.5	110.9	111.4	111.8	112.6	110.1
1971	112.9	113.6	113.9	114.4	114.7	115.2	115.6	115.8	116.1	116.4	116.6	116.9	115.4
1972	117.5	117.8	118.0	118.4	118.6	119.0	119.2	119.6	119.9	120.3	120.5	121.0	119.2
1973	121.8	122.1	122.8	123.2	123.7	124.0	124.4	125.0	125.4	125.9	126.3	126.9	124.3
1974	127.7	128.4	128.7	129.2	129.6	130.2	130.6	131.2	131.8	132.5	133.1	133.7	130.6
1975	134.5	135.1	135.5	135.9	136.4	136.9	137.3	138.0	138.4	139.3	139.9	140.6	137.3
1976	141.2	142.1	142.7	143.2	143.8	144.6	145.0	145.6	146.2	146.9	147.5	148.3	144.7
1977	149.5	150.2	150.8	151.6	152.2	152.9	153.6	154.4	155.3	156.1	157.0	157.9	153.5
1978	158.8	159.7	160.5	161.5	162.7	163.6	164.2	165.1	166.4	167.4	168.5	169.5	164.0
1979	170.3	171.0	171.3	172.0	173.8	174.7	175.9	177.5	179.0	181.4	182.1	182.9	176.0
1980	184.[illegible]	185.6	186.6	187.0	188.9	191.1	192.1	193.2	195.1	197.1	198.3	199.6	191.8
1981	200.9	201.9	203.0	204.2	205.9	206.8	207.8	[illegible].3	211.9	213.6	215.0	216.5	208.2
1982	217.8	218.6	219.6	220.1	221.8	222.6	224.8	226.0	226.9	228.9	230.2	230.8	224.0
1983	232.2	233.1	233.6	234.5	235.1	235.9	237.1	238.2	239.5	240.4	241.3	242.0	236.9
1984	242.9	243.6	244.8	246.4	247.2	248.4	249.7	251.1	252.4	253.8	254.8	256.1	249.3

09/13/95

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Washington, D.C. 20212

Consumer Price Index

All Urban Consumers - (CPI-U)

U.S. city average

Rent, residential

1982-84=100

YEAR	JAN.	FEB.	MAR.	APR.	MAY	JUNE	JULY	AUG.	SEP.	OCT.	NOV.	DEC.	SEMIANNUAL 1ST HALF	SEMIANNUAL 2ND HALF	AVG.	PERCENT CHANGE DEC-DEC	PERCENT CHANGE AVG-AVG
1976	59.6	60.0	60.3	60.5	60.7	61.0	61.3	61.5	61.8	62.1	62.3	62.6			61.1	5.4	5.3
1977	63.2	63.4	63.7	64.0	64.3	64.6	64.9	65.2	65.6	65.9	66.3	66.7			64.8	6.5	6.1
1978	67.1	67.5	67.8	68.2	68.7	69.1	69.4	69.7	70.3	70.7	71.2	71.6			69.3	7.3	6.9
1979	71.9	72.2	72.4	72.7	73.4	73.8	74.3	75.0	75.6	76.6	76.9	77.3			74.3	8.0	7.2
1980	77.8	78.4	78.8	79.0	79.8	80.7	81.1	81.6	82.4	83.3	83.8	84.3			80.9	9.1	8.9
1981	84.9	85.3	85.8	86.3	87.0	87.4	87.8	88.8	89.5	90.2	90.8	91.5			87.9	8.5	8.7
1982	92.0	92.3	92.8	93.0	93.7	94.0	95.0	95.5	95.8	96.7	97.2	97.5			94.6	6.6	7.6
1983	98.1	98.5	98.7	99.1	99.3	99.7	100.2	100.6	101.2	101.6	101.9	102.2			100.1	4.8	5.8
1984	102.6	102.9	103.4	104.1	104.4	104.9	105.5	106.1	106.6	107.2	107.6	108.2	103.7	106.9	105.3	5.9	5.2
1985	108.6	109.2	109.5	110.0	110.9	111.4	111.9	112.6	113.1	114.0	114.8	115.1	109.9	113.6	111.8	6.4	6.2
1986	115.5	115.6	116.2	117.4	117.6	118.0	118.8	119.0	119.6	120.2	120.6	120.8	116.7	119.8	118.3	5.0	5.8
1987	121.3	121.7	121.8	122.0	122.3	122.3	123.0	123.8	124.4	124.8	124.8	125.6	121.9	124.4	123.1	4.0	4.1
1988	126.0	126.3	126.4	126.6	126.9	127.3	127.8	128.4	129.1	129.4	129.8	130.1	126.6	129.1	127.8	3.6	3.8
1989	130.5	130.9	131.1	131.4	131.7	132.3	133.0	133.5	133.9	134.7	135.2	135.5	131.3	134.3	132.8	4.2	3.9
1990	135.8	136.0	136.5	137.0	137.3	137.9	138.7	139.4	140.0	140.5	140.7	141.1	136.8	140.1	138.4	4.1	4.2
1991	141.2	141.5	142.0	142.5	142.8	143.0	143.7	143.7	144.6	144.6	145.0	145.2	142.2	144.5	143.3	2.9	3.5
1992	145.4	145.6	146.4	146.2	146.3	146.6	147.0	147.0	147.2	148.0	148.6	148.6	146.1	147.7	146.9	2.3	2.5
1993	148.9	149.1	149.1	149.7	149.9	150.3	150.4	150.8	151.0	151.4	151.6	151.9	149.5	151.2	150.3	2.2	2.3
1994	152.2	152.8	153.2	153.3	153.3	153.4	153.9	154.5	155.0	155.2	155.6	155.7	153.0	155.0	154.0	2.5	2.5
1995	156.1	156.4	156.7	157.0	157.2	157.5	157.9	158.2					156.8				

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Rent, residential

1982-84=100

YEAR	JAN.	FEB.	MAR.	APR.	MAY	JUNE	JULY	AUG.	SEP.	OCT.	NOV.	DEC.	SEMIANNUAL 1ST HALF	SEMIANNUAL 2ND HALF	AVG.	PERCENT CHANGE DEC-DEC	PERCENT CHANGE AVG-AVG
1914																	
1915												16.1					
												16.0			16.0		
1916																	
1917												15.7			15.9		-0.6
1918												15.5			15.6		-1.9
1919												15.5			15.5		-0.6
1920						15.5						16.8			15.9		2.6
						17.6						18.5			17.8		11.9
1921					19.6				19.9			20.3			19.6	9.7	10.1
1922			20.6			20.9			21.0			21.0			20.8	3.4	6.1
1923			21.2			21.3			21.8			21.9			21.5	4.3	3.4
1924			22.1			22.3			22.6			22.4			22.2	2.3	3.3
1925						22.3			22.3			22.5			22.3		1.4
1926						22.5						22.5			22.5		0.0
1927						22.3						22.1			22.3		-0.9
1928						21.9						21.5			21.8		-2.2
1929						21.2						21.0			21.2		-2.8
1930						20.6						20.3			20.6		-2.8
1931						20.0						19.3			19.9		-3.4
1932						18.5						17.6			18.4		-7.5
1933						16.7						16.2			16.8		-8.7
1934						15.9									15.9		-5.4
1935			15.4				15.4			15.4	15.6				15.4		-3.1
1936	15.4			15.4			15.4		15.5			15.6			15.5		0.6
1937			15.8			16.0			16.1			16.2			16.0	3.8	3.2
1938			16.3			16.4			16.4			16.4			16.4	1.2	2.5
1939			16.5			16.5			16.5			16.6			16.5	1.2	0.6
1940			16.5			16.5			16.5	16.6	16.6	16.5			16.5	-0.6	0.0
1941	16.6	16.6	16.6	16.6	16.6	16.6	16.6	16.6	16.7	16.7	16.8	16.8			16.6	1.8	0.6
1942	16.9	16.9	16.9	16.9	17.0	17.0	17.0	17.0	16.9	16.9	16.9	16.9			16.9	0.6	1.8
1943	17.0	17.0	17.0	17.1	17.1	17.1	17.1	17.1	17.2	17.2	17.2	17.3			17.1	2.4	1.2
1944	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3	17.3						17.3		1.2
1945			17.4						17.4						17.4		0.6

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YEAR	JAN.	FEB.	MAR.	APR.	MAY	JUNE	JULY	AUG.	SEP.	OCT.	NOV.	DEC.	SEMIANNUAL 1ST HALF	SEMIANNUAL 2ND HALF	AVG.	PERCENT CHANGE DEC-DEC	PERCENT CHANGE AVG-AVG
1946			17.4					17.4							17.4		0.0
1947		17.5							18.2			18.5			18.0		3.4
1948			18.7			19.0			19.1			19.3			19.0	4.3	5.6
1949			19.3			19.4			19.4			19.5			19.4	1.0	2.1
1950			19.6			19.7			19.7			20.0			19.6	2.6	1.0
1951			21.0			21.3			21.4			21.7			21.2	8.5	8.2
1952			22.1			22.5			22.3			22.5			22.2	3.7	4.7
1953						22.9						24.0			23.5		5.9
1954						24.2						24.6			24.3		3.4
1955						24.8						25.1			24.8		2.1
1956						25.4			25.5			25.8			25.4		2.4
1957			26.1			26.1			26.2			26.6			26.2	3.1	3.1
1958			27.0			27.1			27.4			27.6			27.2	3.8	3.8
1959			27.8			28.0			28.3			28.6			28.1	3.6	3.3
1960			28.8			29.1			29.2			29.5			29.1	3.1	3.6
1961			29.7			29.7			30.3			30.4			30.0	3.1	3.1
1962			30.7			30.9			31.2			31.5			31.0	3.6	3.3
1963			31.6			32.0			32.0			32.3			31.9	2.5	2.9
1964			32.6			32.6			32.8			32.9			32.7	1.9	2.5
1965			33.2			33.4			33.5			33.6			33.4	2.1	2.1
1966			34.0			34.0			34.4			34.7			34.2	3.3	2.4
1967			34.9			35.0			35.5			35.9			35.2	3.5	2.9
1968			36.5			37.0			37.5			38.1			37.1	6.1	5.4
1969			38.7			39.0			39.5			40.4			39.2	6.0	5.7
1970			41.3			42.0			42.6			43.2			42.0	6.9	7.1
1971			43.8			44.2			44.5			44.8			44.2	3.7	5.2
1972			45.1			45.5			45.8			46.0			45.5	2.7	2.9
1973			46.4			46.8			47.3			47.8			46.9	3.9	3.1
1974			48.4			48.8			49.2			49.8			48.9	4.2	4.3
1975			50.4			50.7			51.5			52.4			51.0	5.2	4.3

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YEAR	JAN.	FEB.	MAR.	APR.	MAY	JUNE	JULY	AUG.	SEP.	OCT.	NOV.	DEC.	SEMIANNUAL 1ST HALF	SEMIANNUAL 2ND HALF	AVG.	PERCENT CHANGE DEC-DEC	PERCENT CHANGE AVG-AVG
1976			53.0			53.8			54.8			55.6			54.0	6.1	5.9
1977			56.9			57.7			58.8			60.3			58.0	8.5	7.4
1978		60.9		61.3		62.7		63.9		63.2		63.7			62.5	5.6	7.8
1979		64.2		64.6		64.7		68.6		69.8		72.4			67.0	13.7	7.2
1980		72.1		73.1		75.0		76.0		78.7		80.0			75.5	10.5	12.7
1981		81.3		82.7		82.2		84.0		84.2		86.2			83.2	7.8	10.2
1982		89.6		89.4		90.5		92.6		93.3		93.6			91.2	8.6	9.6
1983		97.9		98.0		99.1		101.4		103.2		104.3			100.2	11.4	9.9
1984		104.6		106.8		107.8		110.0		111.8		112.9	106.1	111.1	108.6	8.2	8.4
1985		113.5		115.3		116.4		118.9		119.8		123.2	114.8	120.1	117.4	9.1	8.1
1986		125.1		125.3		126.8		129.1		128.8		129.9	125.4	129.0	127.2	5.4	8.3
1987	130.9	131.9	131.5	131.9	132.2	132.7	133.4	133.4	134.1	134.7	134.7	135.4	131.8	134.3	133.1	4.2	4.6
1988	137.5	137.3	137.2	136.8	136.8	137.7	138.3	139.1	141.3	141.6	140.8	141.0	137.2	140.4	138.8	4.1	4.3
1989	141.3	141.2	143.0	143.5	143.9	143.6	143.6	144.1	144.4	146.6	147.1	148.4	142.8	145.7	144.2	5.2	3.9
1990	148.2	148.7	148.8	150.3	149.7	151.3	151.1	151.8	151.4	152.8	153.8	154.2	149.5	152.5	151.0	3.9	4.7
1991	154.3	154.0	155.1	154.8	155.7	156.9	156.9	156.9	158.1	157.2	158.5	158.4	155.1	157.7	156.4	2.7	3.6
1992	158.7	158.8	159.3	158.4	159.0	159.2	158.7	159.8	161.2	162.4	162.8	162.3	158.9	161.2	160.1	2.5	2.4
1993	162.2	162.1	162.6	165.1	164.8	164.2	164.0	164.4	164.6	165.4	166.9	166.1	163.5	165.2	164.4	2.5	2.7
1994	165.8	165.6	166.8	166.9	166.9	167.6	168.4	168.7	168.4	168.3	168.0	168.3	166.6	168.4	167.5	1.3	1.9
1995	168.1	168.5	169.0	169.2	169.4	170.0	170.1	170.6					169.0				

APPENDIX C

RESUME

Kenneth Kalvin Baar
1333 Milvia St.
Berkeley, Ca. 94709

Member of the California Bar

Education:

B.A., 1969, Wesleyan University, Middletown, Conn. major: government

J.D., 1973, Hastings College of Law, Univ. of California, San Francisco, Ca.

M.A., 1982, Urban Planning, University of California at Los Angeles

Ph.D., 1989, Urban Planning, University of California at Los Angeles (Dissertation topic: "Explaining Crises in Rental Housing Construction: Myth and Schizophrenia in Policy Analysis")

Employment:

Consulting, teaching, and researching on housing, real estate, and land use policy

Teaching:

Visiting Assistant Professor, Urban Planning Department, School of Architecture, Planning, and Preservation, Columbia University, New York (Sept. 1994 - April 1995) (courses: Introduction to Housing, Planning Law, Comparative Housing Policy, Land Use Policy and Housing)

Visiting Professor (Fulbright Scholar), Budapest University of Economic Sciences - Real Estate Law and Economics, Urban Planning, and Housing Policy (Sept. 1991 - June 1993)

Instructor, San Francisco State University, Urban Studies Program - Urban Housing, Advanced Housing and Urban Development Policy, Law and Social Change in the City (1983-1984)

(short courses, series of lectures)

Technical University of Budapest, Planning Department Series of lectures in Professional Extension Courses and Undergraduate Courses (1991-1992)

Kiev University Law School, real estate law (1992, one week course)

Warsaw Technical University, Planning Department, urban planning (1992)

Projects: 1980-1994

U.S.Aid for International Development (A.I.D.) funded technical assistance to Albanian Ministry of Construction (Sept. 1993- March 1994)

Study of Hungarian Land Use Regulations (publication and technical assistance sponsored by Urban Institute, Wash. D.C.)

Report for Hungarian Ministry of Justice, Comparison of Landlord-Tenant Law in France, United States, and Hungary (funded by Urban Institute, Wash. D.C.)

Consultant, East European Real Property Foundation, (U.S. A.I.D. funded), development of education and training in Hungary (July 1993)

Consultant, City of Santa Monica, Cal., Incentive Housing Program

Consultant to the cities of Fremont, Oceanside, Ventura, Santee, Salinas, Carpenteria, Milpitas, and Palmdale, California on mobile home space rent control legislation

Consultant to the cities of West Hollywood, Santa Monica, East Palo Alto, Berkeley, and Cotati, California on apartment rent control legislation

Expert witness on behalf of cities in judicial and administrative proceedings on real estate fair return issues (San Francisco, Oceanside, Rancho Mirage, Cathedral City, Berkeley, and Santa Monica, California; Fort Lee, New Jersey)

Consultant, State of New Jersey Attorney General and Public Advocate, on fair return standards under state statute regulating evictions of senior citizens from condominiums

Studies of Impacts of Local Regulations on Housing Supply, Cities of Santa Monica and Fremont, Cal.

Preparation of a Guide for New Jersey Rent Control Boards on Fair Return Standards and Landlord Hardship Applications (National Housing Law Project)

Research and Writing Articles on Inequalities in Property Tax Assessments (Legal Services Corporation, Washington, D.C.)

Consultant, Peter L. Bass & Associates, Development of Contracts with Developers under the California Coastal Conservancy Lot Consolidation Program

Expert Witness, City of San Francisco, on the impacts of city policies on apartment construction in litigation involving applicability of antitrust regulations

Project Director, survey of merchants and commercial property owners for City of Berkeley, Cal., Planning Dept.

Preparation of apartment operating cost studies for the cities of Berkeley, Santa Monica, and Cotati, California)

Consultant, Real Property Division, First Nationwide Bank on disposition of assets in operations inventory

Assistant (on contract) to Deputy City Attorney of San Jose, California on drafting of environmental and subdivision regulations

Publications:

Articles

Baar, "The Right to Sell the 'Im'mobile Manufactured Home in Its Rent Controlled Space in the 'Im'mobile Home Park: Valid Regulation or Unconstitutional Taking?", 24 Urban Lawyer 107-171 (Winter 1992, American Bar Ass'n) cited in Guimont v. Washington Manufactured Housing Ass'n., 854 P.2d.1 (1993, Washington Supreme Court).

Baar, "The National Movement to Halt the Spread of Multi-family Housing (1890-1926)", 58 Journal of the American Planning Association 39 (Dec. 1991)

Baar, "Would the Abolition of Rent Controls Restore a Free Market?", 54 Brooklyn Law Review 1231-8 (1989)

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Baar, "Rent Controls and the Property Tax Base:The Political-Economic Relationship", 3 Property Tax Journal (no. 1) 1-20 (March 1984, International Ass'n. of Assessing Officers)

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Baar, "Guidelines for Drafting Rent Control Laws: Lessons of a Decade", 35 Rutgers Law Review 723-885 (1983) (Cited extensively in Fisher v. City of Berkeley, 37 Cal.3d. 644, California Supreme Court; also cited in Mayes v. Jackson Township, 511 A.2d. 589 (New Jersey Supreme Court, 1986); Yee v. Mobilehome Park Rental Review Board, 17 Cal. App. 1097 (1993, California Court of Appeals); Palomar Mobilehome Park v. City of San Marcos, 20 Cal.R.2d. 371 (1993, California Court of Appeals)

Baar and Keating, "Controlling Rent Control", 11 New Jersey Reporter 19 (Oct. 1981)

Baar, "Property Tax Assessment Discrimination Against Low-Income Neighborhoods", 13 Urban Lawyer 333-405 (1981, American Bar Association)
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15 Clearinghouse Review 467-486 (1981),
1 Property Tax Journal (no. 1) 1-50 (March 1982, International Association of Assessing Officers)

Baar, "Land Banking and Farm Security Loans", 8 Economic Development Law Project Report, (Issue No. 4, 1978)

Baar, "Rent Control in the 1970's: The Case of the New Jersey Tenants' Movement", 28 Hastings Law Journal 631-683 (1977) (cited in Helmsley v. Borough of Fort Lee, 394 A.2d. 65, New Jersey Supreme Court)

Pearlman and Baar, "Beyond the Uniform Relocation Act: Displacement by State and Local Government, 10 Clearinghouse Review 329-345 (1976)

Baar and Keating, "The Last Stand of Economic Substantive Due Process: The Housing Emergency Requirement for Rent Control", 7 Urban Lawyer 446-509 (1975) (cited in Westchester West No.2 Limited Partnership v. Montgomery County, 348 A.2d. 856, 1975 Maryland Court of Appeals)

Articles in Foreign Journals

Baar, "La resistance au logement collectif", Etudes Foncieres, Vol. 67, (June 1995, Paris, France)

Baar,"Impacto del precio del suelo y de las normas sobre su uso en el precio y la distribucion de las viviendas en USA", La Vivienda (1993, National Mortgage Bank of Spain)
["The Impact of Land Costs and Land Regulations on the Cost and Distribution of Housing in the United States"]

Baar,"A Teruletrendezes Dilemmai a Demokratikus Piacgazdasagokban", Ter es Tarsadalom, Vol. 6, no. 1-2, 89-99 (1992, Budapest)
["Dilemmas of Land Use Planning in a Democracy with a Market Economy", Space and Society]

Baar, "Il Movimento Contro Gli Edifici Multifamiliari Negli Stati Uniti, Storia Urbana Vol 66, pp.189-212 (1994, Milan, Italy) [Urban History (journal)] translated version of "The National Movement to Halt the Spread of Multi-family Housing (1890-1926)", 58 Journal of the American Planning Association 39 (Dec. 1991)

Baar, "El Control de Alquileres en Estados Unidos" 35 Estudios Territoriales 183-199 (1991, Madrid) ["Rent Control in the United States"]

Baar, "Il Dibattito Sul Controllo Degli Affiti Negli Stati Uniti", Bolletino Daest (Sept. 1984, University of Venice)
["The Debate Over Rent Controls in the United States"]

Chapters in Books

Baar, Hungarian Land Use Policy in the Transition to a Market Economy with Democratic Controls", Land Tenure and Property Development in Eastern Europe (1993, Association des Etudes Foncieres, Paris)

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Baar, "Rent Control", California Residential Landlord-Tenant Practice, Chapter 9 (1986, California, Continuing Education of the Bar)