STAFF REPORT

CITY OF OCEANSIDE

DATE: July 2, 2013

TO: Chairman and Members of the Manufactured Home Fair Practices Commission

FROM: Neighborhood Services Department

SUBJECT: CONSIDERATION OF A SPECIAL ADJUSTMENT FOR EL CAMINO 76 MOBILE ESTATES

SYNOPSIS

Staff recommends that the Manufactured Home Fair Practices Commission grant El Camino 76 a Maintenance of Net Operating Income (MNOI) increase of $7.85 per space, per month based on the MNOI formula in the Ordinance pursuant to Ordinance § 16B.9 and deny El Camino's request for a larger special adjustment increase based on a modified MNOI formula and return on investment (""ROI") analysis.

BACKGROUND

The Manufactured Home Fair Practices (MHFP) Ordinance provides for annual permissive rent increases equal to 75% of the increase in the consumer price index (CPI) and MNOI increases. The MNOI provisions of Section 16B.9 are designed to allow a park owner to receive a fair return by maintaining the same rate of return it earned in the base year indexed up by 40% of the increase in the Consumer Price Index ("CPI") since the base year. Under the Ordinance it is presumed that the annual permissive increase and any MNOI increase will provide a fair return. However, a park owner may apply for a special adjustment under Section 16B.10, if the owner believes that the application of the permissive and NOI adjustments do not provide a fair return.

ANALYSIS OF THE APPLICATION

An application for a Special Adjustment was filed by El Camino 76 Mobile Estates (El Camino 76), a manufactured home park located in the City of Oceanside. El Camino 76 was built in 1971 and is an all-age park. It is an average quality park in average condition and has 79 rental spaces and one space that is currently used by the resident manager.

The applicant claims the Park is not earning a fair return and seeks a rent increase of $148.56 per space, per month. (Volume II, Attachment 17) This requested total rent increase amount includes a permanent rent increase component and a non-permanent rent increase component as follows:

- A permanent rent increase of $37.42, per space, per month (based on the applicant's modified maintenance of net operating income (MNOI) analysis for 2000 to 2011, which increases base year income by 100% of the increase in the CPI instead of the 40% provided for by the Ordinance).

- A non-permanent total rent increase of $111.14, per space, per month (based on the applicant's capital improvement analysis costs; Ramos v. Neumann lawsuit costs; and legal, consulting and appraisal fees associated with this Application). This $111.14 rent increase would be implemented in the first year and stop at the end of the fifth year. This component includes the following amortized amounts for various expense recoupments:

  - A five-year amortization of $102.11 for the Ramos v. Neumann lawsuit costs; and, other legal and consulting fees
  - A ten-year amortization of $4.65 for recoupment of capital improvement expense related to street improvements and pool restoration
  - A twenty-year amortization of $4.38 for recoupment of capital improvement expense related to the clubhouse and workshop roofs

- A non-permanent total rent increase of $9.03, per space, per month (based on just the applicant's capital improvements analysis). This $9.03 increase would be implemented in the sixth year, and stop at the end of the tenth year. This component includes the following amortized amounts for capital improvement expense recoupment

  - A ten-year amortization of $4.65 for recoupment of capital improvement expense related to street improvements and pool restoration
  - A twenty-year amortization of $4.38 for recoupment of capital improvement expense related to the clubhouse and workshop roofs

- A non-permanent total rent increase of $4.38 per space, per month (based on just the applicant's capital improvements analysis). This $4.38 rent increase would be implemented in the eleventh year and stop at the end of the twentieth year. This component is based on a twenty-year total amortization of $4.38 for recoupment of capital improvement expense related to the clubhouse and workshop roofs

The applicant also requested an alternative "minimum" special adjustment of $100.00 per space, per month, phased-in over a period of four years, at the rate of $25.00 per space, per year. The applicant indicates that if a rent increase were granted under this analysis, it would not take the annual permissive adjustment (increase) provided by the Ordinance until the fifth year after the increase is granted.

The applicant is claiming it incurred attorney's fees and expert costs for presenting the application. Such fees and costs are only recoverable through a separate, temporary increase, if a rent increase is granted. If a rent increase is granted and if the costs claimed are properly documented and reasonable in light of the fees and costs generally incurred in preparing and presenting an application and the extent to which the applicant prevailed on its claims, there will be a separate amortized rent increase that lasts for five years. The amount of any temporary increase that might be granted in this case cannot be determined now because the applicant has not provided all the necessary documentation and does not intend to do so until after the hearing on the application.

The City's survey of the fees and costs claimed by prior applicants in Oceanside and in several other cities for preparing and presenting applications over the past five years has run between $25,000 and $69,000. To date, the applicant is claiming approximately $120,000 in fees and costs. Staff does not consider that amount, even if properly documented, to be reasonable based on what applications generally cost to present and the duplication of effort caused by the applicant's filing of an application, significant delay in responding to the City's initial request for information and eventually submitting a second application. Other considerations may be relevant to the determination of the reasonableness of the fees and costs claimed after all the documentation is provided and the amount of any rent increase granted and the reasons for that increase are known. If any separate increase for fees and costs is granted, the amount allowed will be divided by 80 (number of spaces in the park); then divided by 12; and then amortized over 5 years to determine the amount of the temporary monthly increase.

<u>History of Rent Adjustments at El Camino 76</u>

The ordinance was adopted and became effective in January 1985. At that time, parks had the option of applying for an Initial Permissive Adjustment or an Initial MNOI Adjustment; El Camino 76 elected to apply for an Initial Permissive Adjustment that increased the rent by $56.42 per space per month. Since then, the park has received annual increases equal to 100% of CPI through 1991 and 75% of the increase in the CPI thereafter, pursuant to the Ordinance. Ongoing Pass Thru Adjustments were granted in the following years and amounts.

1986	$ 3.14
1988	$ .34

In 1995, rents were decreased by $22.42 pursuant to Civil Code Section 798.41 when the applicant began separately billing residents for water in addition to the monthly space rent.

El Camino 76 has previously been granted two Special Adjustments. The first Special Adjustment in the amount of $25.00 was effective September 1, 1998. The second Special Adjustment in the amount of $28.56 was effective February 1, 2003. The most recent permissive space rent adjustment of 1.20 percent became effective on July 1, 2013. Currently approved space rents range from $410.97 to $439.22.

On July 5, 2011, El Camino 76 submitted an incomplete special adjustment application requesting a rent increase of $91.12 per space, per month. The park's revised application, received on December 3, 2012, requested a rent increase of $148.56 per space, per month. The requested increase included a permanent rent increase of $37.42 per space, per month and a non-permanent rent increase of $111.14 per space, per month. On June 6 and December 3, 2012; and, January 25, and April 29, 2013, the park owner submitted additional information needed to complete the application. The application included financial information for calendar years 2005-2011; the analysis was based on calendar years 2009-2011. Further information was received on April 29, 2013; and the application was declared complete on May 30, 2013. The public hearing was tentatively scheduled for June 20, 2013, within 60 days from the date the completed application was received by the commission, as required by the Ordinance. The park representative, Michael St. John, advised staff that the hearing date of June 20, 2013 would not work for Mr. Neumann's attorney and rejected the date. The applicant was informed in a letter dated May 30, 3013, that the hearing was scheduled for July 2, 2013. The applicant submitted two letters dated June 2 and June 5, 2013 providing additional information.

Section 16B.10(c) of the Ordinance expressly provides the presumption that the permissive, MNOI and pass-thru adjustments provide the park owner with a "just and reasonable" or "fair" return. The law requires that a mobile home park owner be permitted to receive a fair return on the park. The courts have not defined "fair return" and Cities may use any fairly constructed method of determining fair return; no particular formula or methodology is required by the courts. However, Dr. Gibson's historical cost (book assets) approach to determining fair return has been approved by the Courts and the MNOI formula in the Ordinance was approved by the court of appeal in *Oceanside Mobilehome Parkowner's Association v. City of Oceanside* (1984) 157 Cal.App.3d 887. That case also provided the following guidance "the rent provided must be high enough (1) to encourage good management including adequate maintenance of services, (2) to furnish a reward for efficiency, (3) to discourage flight of capital from the housing market, and (4) to enable operators to maintain and support their credit. A just and reasonable return is one which is generally commensurate with returns on

investments in other enterprises having corresponding risks. On the other hand a fair return is not so high as to defeat the purposes of rent-control, nor permit landlords to demand of tenants more than the fair value of the property and the services which are provided". Determining fair return requires balancing the interests of park owners in earning a fair return with that of tenants in not being charged excessive rent increases. *Kavanau v. Santa Monica Rent Control Bd.* (1997)16 Cal. 4th 761. The courts have further explained that in determining the return being earned by the Park, it is necessary to consider the Park as a whole. It is not appropriate to break up the Park into separate businesses, one for rent-controlled spaces and one for exempt spaces. *Morgan v. City of Chino* (2004) 115 Cal.App.4th 1192*; Carson Harbor Village v. City of Carson Mobilehome Park Rental Review Board* (1997) 70 Cal. App. 4th 280.

The City employed independent expert consultants to analyze El Camino 76's application and assist the Commission in making its determinations. One is the economist, James A. Gibson, Ph.D., with NewPoint Group Management Consultants, and the other is appraiser James Brabant, MAI. Dr. Gibson's report addresses the applicant's claim that a rent increase of $148.56, including a permanent increase of $37.42 and a temporary increase of $111.14 is required to provide a fair return under the applicant's modified maintenance of net operating income (MNOI) and ROI approach to determining fair return. Mr. Brabant's report provides an opinion of the average space rental value of spaces in El Camino 76 as of July 1, 2011.

Dr. Gibson's June 25, 2013 report also discusses each of the 12 factors that the Commission is to consider pursuant to section 16B.15 (d) (7) of the Oceanside Municipal Code at a "special adjustment" hearing. Dr. Gibson's report suggests that of the 12 factors, five have greater importance and seven have minor importance. However, under the Ordinance no one factor can be determinative; the factors must be considered together and weighed and balanced by the Commission. Some factors may be more important in one application while others are more important in another application, but the result must allow a fair return to the applicant. Factor 11 is, however, the most important because the Ordinance and applicable law require that the applicant be provided with a fair return. Dr. Gibson's report contains an analysis of the return being earned by the Park utilizing the return on book value or return on book assets approach, which has been approved by the courts and is discussed below under Factor No. 11. Dr. Gibson's report shows that the applicant is already earning a fair return.

The applicant submitted several documents in support of the rent increase, including (a) a maintenance of net operating income (MNOI) adjustment analysis; (b) an Oceanside's fair return system analysis; (c) a return on investment (ROI) analysis; and (d) a "Fair Return and the California Courts" report, written by Dr. Michael St. John, and a "Special Adjustment Application Introduction", written by Mr. Terry Dowdall. The applicant also submitted an appraisal report by John Neet, MAI, dated September 2, 2010, which includes an estimate of the property

market value, rental survey, summary of historic financial records and sales comparison. In addition, the applicant submitted seven large binders; six are labeled "Monthly Receipts, Invoices/Statements" and are provided for the years 2005-2011. A seventh binder is labeled "2011 Bank Statements, Transaction Detail by Expense Account Report, Receipts/Invoices, Statements Sorted by Expense Account". These large binders are available for review at City of Oceanside, Neighborhood Services Department, Housing Division offices.

Mr. Brabant prepared a rental analysis for the Commission. The purpose of the analysis was to form an opinion of rental value of the spaces in El Camino 76 based on the rents charged for comparable spaces. The applicant also submitted an appraisal by John Neet, MAI. The City did not conduct an appraisal of the Park based on the applicant's (Dr. St. John's letter dated November 21, 2012), statement that the park did not intend to update or rely on Mr. Neet's appraisal of August 31, 2010 because it was irrelevant to determining fair return. Thus, Dr. St. John, the applicant's representative, stated that: "We accept the burden of proving that a space rent increase is required by the fair return principle and under the Ordinance. There is no need for an appraisal for this purpose".

The Ordinance requires the Commission to consider rents in comparable parks and requires the consideration of all relevant evidence, and the application form requests that applicants submit a park appraisal. Although the rents in comparable parks and an appraisal of the Park often provide useful information, comparable rents cannot be used to determine whether a park is earning a fair return. They can, however, assist in determining where in the "zone of reasonableness" rents should be set, because the courts have explained that there is not just one rent that will provide a fair return. Further, fair return cannot be based on current fair market value of a park. Although the courts have repeatedly stated that no particular method of determining fair return must be used, the courts have criticized attempts to use current fair market value as the basis for determining fair return and have approved the historical cost/return on assets or book value approach used by Dr. Gibson. The courts have also approved the MNOI formula set forth in the Ordinance.

STAFF'S ANALYSIS UNDER THE MNOI FORMULA IN THE ORDINANCE

As noted above, the courts have approved the formula in the Ordinance, which uses 40% indexing of the base rent rather than the 100% advocated by the applicant. Further, *H.N Francis Berger Foundation v. City of Escondido* (2005) 127 Cal.App.4th 1, explains that using 100% indexing in the MNOI formula is not required because park owners typically derive a return on their investment not only from income the park produces, but also from an increase in the property's value or equity over time and that the leveraged nature of the investment in a park also allows a fair return without 100% indexing.

In performing the MNOI analysis of the application under the Ordinance, the City used the same base year, 2000, as did the applicant. This is the required base year under the Ordinance because that is the data year on which the applicant's last special adjustment rent increase was based. Staff, however, deleted the current operating expenses claimed by the applicant for preparing and presenting the application for the reasons set forth above (those expenses will be considered at a subsequent hearing if a rent increase is granted to the applicant) and increased the base year net operating income by including all the income from spaces occupied by Park-owned homes. Staff also reduced the amortized amount allowed for the cost of purchasing the Park-owned homes by using 7% interest in the amortization calculations because that is the legal rate of interest, which is high considering the interest rates being charged given the state of the economy in the past few years, and is the statutory legal rate of interest, rather than the 8% rate of interest used by the applicant. The following chart shows the applicant's calculations and staff's calculations side by side. It shows that the applicant is entitled to monthly space increases of $7.85 under the Ordinance's MNOI formula.

Justified NOI Adjustment Based on Staff Analysis

	Base Year	**Current Year**	
	Park Owner Projections (See Application, Tab 20, Table 4)		**Staff Analysis**
CPI	**182.80**	**252.91**	
Gross Income	**360,803.85**	**634,151.75**	**654,357.83** (634,357.83+20,206.08, lease premium excluded by Park Owner)
Operating Expenses	**174,189.50**	**481,837.97**	**446,653.73***
Net Operating Income (NOI) (Gross Income –Operating Exp.)	**186,614.35**	**152,313.78**	**207,704.10**
Pct. Increase in CPI Since Base Year		**38.4%**	**38.4%**
Pct. Indexing Adjustment of Net Operating Income		**38.4%**	**15.3%** (40% of 38.4%)

Adjusted Fair Net Operating Income *(Base Year Net Operating Income Adjusted by Indexing Adjustment*		**258,187.29** (186,614.35 adjusted by 38.4%)	**215,243.52** (186,614.35 adjusted by 15.3%)
Required Rent Adjustment *(Adjusted Fair Net Operating Income minus Current Year Net Operating Income)*		**105,873.51** (258,187.29-152,313.78)	**7,053.65** (215,243.52- 207,704.87)
Required Rent Adjustment/ Space/Month		**110.28** 105,873.51/ (12 mos.*80 spaces)	**7.85** 7,053.65/ (12 mos.*80 spaces)

*$481,837.97 minus $30,663.77 claimed as the amortized cost of preparing the application and minus $4,521.27 to adjust for use of 7% rather than the 8% interest used by the applicant for the amortized cost of purchasing the park owned homes.

Dr. Gibson's Analysis

Dr. Gibson's report summarizes the evidence in the application to each of the Factors set forth in § 16B.10 and his analysis under Factor 11 summarizes his ROI analysis.

His report notes and staff reiterates that although each of the factors can be helpful in deciding some applications, each is not always applicable to a particular application. The factors are intended to assist in determining whether a rent increase is needed to allow the applicant to earn a fair return. Thus, the one factor that is always relevant and of particular importance is the fair return analysis discussed in factor 11, which is addressed in the MNOI analysis as well as in the expert reports.

#1. Changes in Consumer Price Index ("CPI"): the park received rent increases equal to 75% from 1992 to 2013 and 100% of the increase in the CPI from 1985 to 1991 through annual permissive adjustments every year since the adoption of the Ordinance. The applicant claims that the costs of operation are at, or higher than, the level of the increase in the CPI, while rent levels increased at a rate below the CPI increase. However, there is no entitlement under the applicable law or the Ordinance that income increase each year in an amount equal to 100% of the increase in the CPI, and a park may be earning a fair return even

if its income is not increasing in an amount equal to the increase in the CPI. Moreover, this factor like the others cannot by itself be determinative of whether an increase is granted or the amount of any increase that should be granted.

#2. Rents for comparable mobile home spaces in the City of Oceanside: Mr. Brabant's report compared this Park with the nine other parks he found to be the most comparable to El Camino 76. He found El Camino 76 to be an average quality park currently in average condition. The comparable rentals produced overall average rents between $332 and $553 per month, for spaces subject to rent control. Three of the comparable parks have long-term leases that are exempt from rent control; the exempt rents ranged from $493 to $700 per month. The restricted rents and exempt rents at the comparable parks were both considered in Mr. Brabant's analysis. Based on his survey, an overall average rental value range is $400 to $450 per month, with a point estimate of $425 per month for an average rental space in El Camino 76. This translates into an average increase of $13 per month as of July 1, 2011. Mr. Neet did not base his report on all the rents in the parks he considered and used only those rental values that in his opinion represented what rents should be in an unregulated market to arrive at a market rental rate of $560 per space, per month.

The courts have explained that there is a range of rents that will provide a fair return; the courts refer to this as the "zone of reasonableness". Thus, actual rents in comparable parks as opposed to estimated market rents can be helpful in deciding where in the range of reasonableness a rent increase should fall when a rent increase is required to provide a fair return. However, if no increase is necessary to allow a fair return, the factor is not relevant.

#3. Length of time since the last rent increase: As set forth above in factor 1, this Park has received a rent increase annually based on 75% of the increase in the CPI. The most recent permissive space rent adjustment of 1.20 percent became effective on July 1, 2013.

#4. Capital improvements made to the park: for direct capital improvements, no increase is justified under this factor because capital improvements made to the park were included in the assets in Dr. Gibson's book assets analysis, which is discussed under factor 11 and in his report in terms of the return on total book assets analysis.

#5. Changes in Property Taxes or other assessed taxes to the park: Property taxes increased $891 over two years from 2009 to 2011. Dr. Gibson calculates that based on this factor alone, a $0.94 cent increase is

justifiable. However, rent increases are not determined or calculated based on just one factor.

#6. Rent Paid by Park Owner for Leased Land: does not apply.

#7. Changes in utility charges or rates: there were no changes to consider because the residents pay for their own utilities and the applicant did not separate out any utility expenses for the common areas that are not billed to the residents.

#8. Changes in reasonable operating and maintenance expenses: the Park's adjusted and normalized net income before interest and taxes from the Park increased from $160,822 in 2009 to $176,354 in 2011, or a $15,532 increase, indicating a $0.00 rent increase. Adjusted and normalized net income before interest and taxes for the Park increased from $163,535 in 2010 to $176,354 in 2011, or a $12,819 increase.

#9. The need for repairs, etc.: The Applicant does not list the need for repairs caused by circumstances other than ordinary wear and tear as a rent increase factor.

#10. The amount and quality of services and amenities provided, etc.: Park amenities include a clubhouse, pool, paved play area and laundry room. Staff is unaware of any increased amenities. Most of the amenities are natural conditions or characteristics of the park, at no additional costs to the Applicant, such as weather conditions, distances to the Oceanside Beach and shopping malls, number of spaces and the average space rent.

#11. The Park Owner/Applicant's Investment, additional investments, appreciation, depreciation, and possible tax benefits: Dr. Gibson's analysis of El Camino's book value or assets and the return on those assets shows that when the Park as a whole, all 79 rental spaces, is considered, it earned a return on investment of 12.32% in 2009, 12.74% in 2010 and 14.39% in 2011. If the Park's adjusted normalized income before taxes is averaged over the three year period, it has been earning 13.15%. Dr. Gibson's report determined that the benchmark fair return for investments of the size of El Camino 76 is approximately 7.75%. The applicant uses 7% rate of return in its ROI analysis but applies that rate to an inflated investment. Dr. Gibson's analysis also shows from 2009 to 2011 total adjusted and normalized net income before interest and taxes increased from $160,822 to $176,354, for a $15,532 increase, or approximate 10 percent increase. Furthermore, the analysis shows that El Camino had a positive cash flow in each of the three years, 2009-2011. This cash flow for 2011 of $265,598 represents a cash flow return of $3,362 per space, per year and this is the equivalent to a cash flow

return of $280 per space, per month. The applicant's fair return analysis concludes that a rent increase is necessary despite this data because it claims that its modified MNOI standard using 100% of the increase in the CPI to index its base year expenses or its ROI analysis using an investment increased by 100% of the increase in the CPI since the base year must be used to determine whether it is earning a fair return. However, as set forth above, the courts have approved the historical cost approach, which depreciates assets rather than indexing them (increasing them) by 100% of the increase in the CPI and have approved using 40% of the increase in the CPI in the MNOI formula.

#12. Any particular hardship circumstances of the park: The Applicant does not list hardship to the residents as a rent increase factor. However, the applicant does state that, "as to the park owners, it is a legally impermissible hardship to require a park owner to operate, maintain, protect against threats to property rights, and improve a mobilehome park without allowing a fair return and commensurate remuneration for the risks of commercial property investment". Owner hardships include the defense of the Ramos case and the requirements related to the filing and presentation of a rent increase application.

Appraiser Brabant's Analysis

As set forth above, one of the factors the City is required to consider even though it cannot be determinative, are the rents charged for comparable spaces in the City of Oceanside. The appraisal report submitted by James Brabant, MAI considered the rents charged in comparable parks in the City for both rent controlled spaces and exempt spaces. He concluded that those rents were higher than those in El Camino by approximately $13. One of the reasons the rents charged in comparable parks cannot be determinative is that they do not provide any information concerning the circumstances in those other parks and do not provide any information about the return being earned by those parks.

CITY ATTORNEY'S ANALYSIS

The procedure is in compliance with Chapter 16B of the Oceanside City Code.

RECOMMENDATION

Staff finds the ROI analysis by Dr. Gibson showing no rent increase is required for the applicant to earn a fair return to be more credible than the various scenarios presented by the applicant and the applicant's experts and found no evidence that granting an MNOI increase based on the formula in the Ordinance is not sufficient to provide a fair return. The applicant's evidence simply shows that if you use the methods of determining fair return advocated by the applicant a larger rent increase would be required. The law, however, is clear that the City

may apply any method of determining fair return that is reasonable, and both Dr. Gibson's approach and the MNOI formula in the Ordinance have been approved by the courts.

Under the Ordinance, the Commission should grant an increase shown to be necessary under the Ordinance's MNOI formula. Staff, therefore, recommends that the Commission grant the applicant an MNOI increase pursuant to the formula in the Ordinance of $7.85, per space, per month.

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