Preliminary Decision, March 28, 2012

PRELIMINARY ADMINISTRATIVE DECISION

FAIR RETURN RENT INCREASE PETITION
CARROLL GARDENS APARTMENT COMPLEX

(26, 28, 30, & 32 Lee Avenue and 7401, 7403, & 7011 Hancock Avenue)

(Case # 2011-11L)

(Takoma Park, Maryland)

TIME PERIODS FOR RESPONSES TO PRELIMINARY DECISION

The tenants and the landlord shall have 30 calendar days to file written objections from the date of mail service by the landlord on the tenants of this Official Preliminary Decision. If no objections are filed within this period this Decision shall become the final decision of the Commission.

Objections should be mailed or submitted in person to: Commission on Landlord-Tenant Affairs, c/o Jean Kerr, 7500 Maple Avenue, Takoma Park, MD 20912 or submitted by email to: JeanK@takomagov.org

Kenneth K. Baar, Ph.D.
Rent Analyst on behalf of the Commission
March 28, 2012

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Appendices

Summary

Apartment owners have a right to a fair return under rent regulation. Under the Takoma Park rent stabilization ordinance fair return is defined as base period net operating income adjusted by 70% of the percentage increase in the Consumer Price Index (CPI) from the base year to 2007 and 100% of the percentage increase in the CPI since 2007.

In this case, the apartment owner used 1990 as a base year.

In 2010, the operating expenses were $171,834.71 over the level imputed for 1990, an increase of $213.72/ apartment unit / month compared with rent increases of $273.43 / apartment unit/month during this period.

While the rent increases were adequate to cover operating cost increases, they did not permit the amount of growth in net operating income required to provide a fair return. From 1990 to 2010, net operating income increased by $60,917.29 - $75.77 / apartment unit / month (from $220.06 / apartment unit / month to $295.83 / apartment unit / month.) In percentage terms the increase was 34.4%.

Under the fair return standard, the apartment owner is entitled to a net operating income which is 57% above the base year level. An additional, rent increase of $40,267.16 per year or $50.53 / apartment unit / month is required to provide this return. (See table below.)

Calculation of Fair Return Rent Adjustment

Base Year NOI	
Rental Income	430,524.00
Operating Expenses	253,592.00
NOI	176,932.00
Fair NOI Adjustment	
Indexing Pct. Adjustment of Base Year NOI	57.0%
Fair NOI - (Base Year NOI Adjusted by Pct Indexing Adjustment) (176,932 x 1.57)	277,783.24
Current NOI	237,155.68
Rent Adjustment (Fair NOI - Current NOI)	40,267.16
Rent Adjustment / Unit / Month	$50.53

The Analyst

The analyst has a Ph.D in urban planning and is an attorney.

His articles on fair return issues have been cited in decisions of the California and New Jersey Supreme Courts and in numerous California Court of Appeal decisions. Over the past 30 years, he has served as a consultant to about thirty California jurisdictions on issues related rent stabilization and has prepared fair return reports for approximately twenty cities in rent control fair return cases.

The analyst has published extensively on housing and real estate issues. Also, he has served as a consultant to the World Bank and U.S. AID on policy issues in East European nations undergoing economic transition and on two occasions has been a visiting Fulbright professor in East Europe.

Appellate Court Opinions Relying on the Testimony of Kenneth K. Baar

Rainbow Disposal Co., Inc. v. Mobilehome Park Rental Review Board, 64 Cal. App.4th 1159 (1998) California Court of Appeal

MHC Operating Limited Partnership v. City of San Jose, 106 Cal. App.4th. 204 (2003) California Court of Appeal

Hillsboro Properties v. Public Utilities Commission, 208 Cal. App. 4th 246 (2003)

Berger Foundation v. Escondido, 127 Cal. App.4th 1 (2005) California Court of Appeal

Los Altos El Granada Investors v. City of Capitola, 139 Cal.App.4th 629 as modified by 140 Cal.App.4th 135c (2006)

Appellate Court Opinions Citing Law Review Articles of Kenneth Baar About Rent Regulations

Westchester West No.2 Limited Partnership v. Montgomery County, 246 Md. 448, 348 A.2d. 856 (1975) Maryland Court of Appeals

Helmsley v. Borough of Fort Lee, 78 N.J. 200; 394 A.2d. 65 (1978) New Jersey Supreme Court, appeal dismissed, 440 U.S. 978, 99 S.Ct. 1782, 60 L.Ed. 2d. 237 (1979)

Fisher v. City of Berkeley, 37 Cal.3d. 644 (1984) California Supreme Court; affirmed, 475 U.S. 260, 106 S.Ct. 1045, 89 L.Ed.2d. 206 (1986)

Oceanside Mobile Home Park Owners Association v. City of Oceanside, 157 Cal.App.3d. 887 (1984) California Court of Appeal

Mayes v. Jackson Township, 103 N.J. 362; 511 A.2d. 589 (1986) New Jersey Supreme Court; cert. denied, 479 U.S. 1090, 107 S.Ct. 1300, 94 L.Ed. 2d. 155 (1987).

Yee v. Mobilehome Park Rental Review Board, 17 Cal. App. 4th 1097 (1993) California Court of Appeal

Palomar Mobilehome Park v. City of San Marcos, 16 Cal.App.4th 481 (1993) California Court of Appeal

Guimont v. Clarke, 121 Wash. 2d. 586; 854 P.2d.1 (1993) Washington Supreme Court; cert. denied, 510 U.S. 1176, 114 S.Ct. 1216, 127 L.Ed.2d. 563 (1994)

Kavanau v. Santa Monica Rent Control Board, 16 Cal.4th. 761 (1997) California Supreme Court); cert. denied, 522 U.S. 1077, 118 S.Ct. 856, 139 L.Ed. 2d. 755 (1998)

Rainbow Disposal Co., Inc. v. Mobilehome Park Rental Review Board, 64 Cal.App.4th 1159 (1998) California Court of Appeal

Quinn v. Rent Control Board of Peabody, 45 Mass. App.Ct. 357, 698 N.E.2d.911 (1998, Massachusetts Court of Appeal)

Galland v. City of Clovis, 24 Cal.4th 1003 (2001) California Supreme Court; cert. denied, 534 U.S. 826, 122 S.Ct. 65 (2001)

MHC Operating Limited Partnership v. City of San Jose, 106 Cal. App.4th 204 (2003) California Court of Appeal

Berger Foundation v. Escondido, 127 Cal.App.4th 1 (2005) California Court of Appeal

T.G. Oceanside L.P. v. City of Oceanside, 156 Cal. App.4th. 1355 (2007) California Court of Appeal

I. Introduction

A. The Ordinance

The Takoma Park rent stabilization ordinance permitted annual rent increases equal to 70% of the percentage increases in the Consumer Price Index (CPI) from 1992 to 2007, and has permitted annual rent increases equal to 100% of the percentage increase in the CPI since 2007.

In addition, apartment owners may petition for additional rent increases pursuant to a fair return standard. The right to a fair return under regulation is a constitutional right. In the Takoma Park ordinance, fair return is defined as the base period net operating income adjusted by 70% of the percentage increase in the CPI from the base year to 2007 and 100% of the percentage increase in the CPI since 2007. (This type of standard is known as a "maintenance of net operating income" [MNOI] standard.)

Under the ordinance, an owner may select 1979, 1990, or 2000 as the base year in a fair return petition.[1]

B. Judicial Guidelines for Fair Return

Since this is the first fair return application that the Commission on Landlord-Tenant Affairs has received in several years, some discussion of judicial standards regarding fair return under rent stabilization is appropriate.[2]

Most of the judicial precedent regarding fair return under rent stabilization comes from New Jersey and California appellate court decisions.

Fair return is a complex concept. In 1993, a California Court of Appeal noted the complexity of the fair return issue:

> **What appears at first blush to be a simple question of substantial evidence turns out to be something considerably more complex when one realizes that the formula for determining a "fair return" is hotly debated in economic circles and**

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1 Sec. 6.20.090. B.2.

2 For background discussion of fair return issues see Baar, "Guidelines for Drafting Rent Control Laws: Lessons of a Decade," 35 *Rutgers Law Review*, 723-885 (1983) and Baar, "Fair Return under Mobilehome Park Space Rent Controls: Conceptual and Practical Approaches:, 29 *Real Property Law Reporter* 333 (Sept. 2006, California Continuing Education of the Bar [CEB])

> **has been the subject of sparse, scattered, and sometimes conflicting comment by appellate courts. In particular, only the broad outlines have been discussed in California decisions.**[3]

The courts have repeatedly reiterated that: **"a governmental entity may choose to regulate pursuant to any fairly constructed formula"** and that: "**[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. ... The method of regulating prices is immaterial so long as the result achieved is constitutionally acceptable.**"[4]

The Courts have also repeatedly reiterated the principle that there is a "range" of rents that may be considered reasonable.

One California Court of Appeal, relying on precedent from the U.S. and New Jersey Supreme Courts, explained:

> **There is a range of rents which can be charged, all of which could be characterized as allowing a "just and reasonable" return. (See Hutton Park Gardens v. Town Council (1975) 68 N.J. 543 [350 A.2d 1, 15] [the terms "just and reasonable" and "confiscatory" are not precise formulations]; Power Comm'n v. Pipeline Co. (1942) 315 U.S. 575, 585 [86 L.Ed. 1037, 1049, 62 S.Ct. 736, 743] [there is a zone of reasonableness which is higher than a confiscatory rate].) Thus, many decisions by rent control boards will focus on the issue of where the requested increases fall within the range of possible rents -- all of which rents would allow the owner a return sufficiently "just and reasonable" as to not be constitutionally confiscatory.**[5]

While the courts have held that no specific formula is required and that a range of rents may be considered reasonable, they have set forth some criteria for fair return. However, those guidelines - such as "commensurate with returns ... in other enterprises having comparable risks" or evaluating the "interests of the investor" and the "interests of the consumer" - have been largely theoretical.

In 1975, the New Jersey Supreme Court set forth general criteria for a fair return which have been included in subsequent fair return opinions by California appellate courts.

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3 *Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com.*, 16 Cal.App.4th 481, 484 (California Court of Appeal)

4 *Rainbow Disposal Co. v. Escondido Mobilehome Rent Review Bd.* 64 Cal.App.4th 1159, 1172 (1998, California Court of Appeal)

5 *San Marcos Mobilehome Park Owners' Assn. v. City Of San Marcos*, 192 Cal.App.3d 1492, 1502-1503 (1987, California Court of Appeal)

> **...the return should be one which is generally commensurate with returns on investments in other enterprises having comparable risks. Determination of what level of return is 'just and reasonable' involves evaluation not only of the interests of the investor but also of the interests of the consumer and of the general public sought to be advanced by the regulatory legislation.**[6]

In 1997, the California Supreme Court reiterated longstanding principles for fair return that have been set forth in utility cases and rent control fair return cases, stating that fair return: 1. "**involves a balancing of the investor and consumer interests,**" 2.should be a "**return ... commensurate with returns on investments in other enterprises having corresponding risks.**", and **3. "should be sufficient ... to attract capital.**"[7]

In 2001, the California Supreme Court held that the concept of "fair rate of return" is a legal term which refers to a "**constitutional minimum**", although the terminology is borrowed from finance and economics. The return must "allow Park Owner to continue to operate successfully."

> **Although the term "fair rate of return" borrows from the terminology of economics and finance, it is as used in this context a legal, constitutional term. It refers to a constitutional minimum within a broad zone of reasonableness. As explained above, within this broad zone, the rate regulator is balancing the interests of investors, i.e. landlords, with the interests of consumers, i.e. mobilehome owners, in order to achieve a rent level that will on the one hand maintain the affordability of the mobilehome park and on the other hand allow the landlord to continue to operate successfully. [cite omitted]. For those price-regulated investments that fall above the constitutional minimum, but are nonetheless disappointing to investor expectations, the solution is not constitutional litigation but, as with nonregulated investments, the liquidation of the investments and the transfer of capital to more lucrative enterprises.**[8]

In *Fisher v. City of Berkeley*, the California Supreme Court identified four types of fair return standards under rent controls: (1) cash flow/return on gross rent; (2) return on equity (investment); (3) return on value; (4) percentage net operating income; and (5) maintenance of net operating income.[9] The Court rejected the apartment owner's contention that a fair return on value was constitutionally required and concluded that this type of standard is "circular" in the context of a rent

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6 *Hutton Park Gardens v. Town of West Orange*, 350 A2d. 1, 15 (1975, New Jersey Supreme Court).

7 *Kavanau v. Santa Monica Rent Control Board,* 16 Cal.4th 761, 772 (1997, California Supreme Court)

8 *Galland v. Clovis*, 24 Cal.4th 1004, 1026 (2001)

9 *Fisher v. City of Berkeley*, 37 Cal.3d. 644, 680 (1984, California Supreme Court)

regulation, since value depends on the rent that is permitted.[10]

An exception to the theoretical nature of the judicial guidelines has been the concept of a "floor" for fair return - the preservation of prior levels of net operating income. In 1975, the New Jersey Supreme Court ruled that: "At some point, steady erosion of NOI becomes confiscatory."[11] Subsequently, a California Court of Appeal ruled in 1983[12] and the State Supreme Court ruled in 1984,[13] that net operating income may not be frozen. While the California courts have held that net operating income may not be frozen, they have rejected the contention that net operating income must be allowed to increase at the full rate of increase in the CPI (the rate of inflation) and have upheld standards which provided for indexing net operating income by 40% or 50% of the percentage increase in the CPI.[14] They have not set forth a minimum rate at which net operating income must be allowed to increase.

In the following decades, the MNOI standard has been approved by the courts. In *Rainbow Disposal v. Mobilehome Park Rental Review Board)* the Court concluded that the MNOI formula is a "fairly constructed formula" which provides a ""just and reasonable" return on ... investment," even if another formula may provide a higher return.[15]

Rationale for the Use of an MNOI Standard In a Fair Return Case

There are strong rationale for the use of an MNOI standard. The MNOI type of standard may be contrasted with a "rate of return" standard, which designates a particular rate of return on overall investment or equity or value as fair. The problem with rate of return standards is the reality that ratios of income to cash investment, current equity, overall investment, and value vary among properties depending on such factors as length of ownership and market expectations about appreciation. Therefore, rather than designating a particular ratio as fair, MNOI standards pursue the best available alternative, which is to preserve prior NOI levels, taking into account inflation since

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10 Id.

11 *Helmsley v. Borough of Fort Lee*, 394 A.2d. 65, 76 (1978, New Jersey Supreme Court)

12 *Cotati Alliance for Better Housing v. City of Cotati*, 148 Cal.App.3d 280,293 (1983, California Court of Appeal)

13 *Fisher v. City of Berkeley*, 37 Cal.3d. 644, 681 (1984, (California Supreme Court)

14 *Berger v. Escondido*, 127 Cal.App.4th 1, 13-15 (2005, California Court of Appeal); *Stardust Mobile Estates v. San Buenaventura*, 147 Cal.App.4th 1170, 1182 (2007)

15 *Rainbow Disposal Co. v. Escondido Mobilehome Rent Review Bd*,. 64 Cal.App.4th 1159, 1172 (1998, California Court of Appeal)

the base period. Under most of the MNOI standards, a pre-rent control net operating income is seen as reasonable base because it is based on the market, rather than regulation. The standard avoids the problems of circularity associated with return on investment standards and cannot be manipulated through increased investments.

In Oceanside Mobilehome Park Owners' Ass'n v. City Oceanside[16] and Baker v. City of Santa Monica[17], California appellate courts upheld maintenance of net operating income fair return standards. In Oceanside the Court found that the fair return standard was reasonable because it allowed an owner to maintain prior levels of profit.[18]

In 1993, the California Court of Appeal commented: "The maintenance-NOI approach has been praised by commentators for both its fairness and ease of administration. ... It was approved by this court in Oceanside Mobilehome Park Owners' Assn. v. City of Oceanside [cite omitted]."[19]

II. Carroll Gardens Rent Increase Application

A. Rental Income

The Carroll Gardens apartment complex has a total of 67 apartment units spread among seven buildings.

From 1990 to 2010 rents have increased by 51%, from an average of $535.48 to an average of $808.91, compared to a 68% increase in the CPI during this period.

Heat, water, electricity, and trash collection are included services which are not separately charged to the tenants.

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16 157 Cal.App.3d.887; 204 Cal.Rptr.239 (1984).

17. *Baker v. City of Santa Monica*, 181 Cal.App.3d. 972 (1986, California Court of Appeal) .

18 157 Cal.App.3d.887, 902-905; 204 Cal.Rptr.239, 249-251 (1984) .

19 Palomar Mobilehome Park Assn. v. Mobile Home Rent Review Com., 16 Cal.App.4th 481, 486 (1993, California Court of Sppeal))

B. Operating Expenses

1. Overview

Under the ordinance, in a fair return application, an apartment owner may elect to impute base year operating expenses for the year 2000 as 60% of rental income.[20] In this case, the owner made this election. In this case, the base year rental income was $430,524. The imputed operating expenses are $253,592.

Applicants are required to submit operating expense information for the "current" year and the two prior years. In this case, the application was submitted in November 2011 and the current year was 2010.

The reported operating expenses for 2010 were $498,179.55, 96.4% above the imputed expense level for 1990. The owner supplied documentation of 2008 through 2010 expenses which was thoroughly reviewed by City staff for the purpose of assuring that level of claimed expenses for each category was documented. As a result of the staff review, minor modifications were made to the totals originally calculated by the owner.

2. Changes in Reported Costs from 2008-2010

This subsection discusses increases in operating costs between 2008 and 2010. In order to place this discussion in perspective it should be noted that it does not consider the increases in operating costs from 1990 to 2008.

It is particularly notable that the reported operating expense levels for 2010 were substantially higher than the expense levels for the two prior years. The 2010 expenditure of $498,179.55 compared with $414,519.07 in 2009 and $366,715.75 in 2008. The increase from 2008 to 2010 was 35.8% ; $163.51 / unit / month.

More than half of this increase was attributable to an increase in building maintenance and repairs expenses from $24,413.11 in 2008 to $48,946.96 in 2009 to $95,367.10 in 2010. Within the maintenance and repair category, the combined cost of replacements of underground water pipes and heating duct pipes- $44,470 and boiler repairs - $25,570 is virtually equal to the $70,953 difference in maintenance and repair costs between 2008 and 2010

If the operating expense levels of the current year are exceptional, rather than likely to be recurring on annual basis, their incorporation into the fair net operating income calculation will

20 Sec. 6.20.090.B.2

provide more than a fair return in the following years.

The other half of the increase increase in operating costs was attributable to increases in utility costs and property taxes.

Water and sewer costs increased by 112%, from $13,128 to $27,937.69, an increase of $14,809.10 ($18.42 / unit / month) between 2008 and 2010. These two services are billed by a single provider and sewer costs are a function of water usage. The rate for these services increased by 66% during this period. However, there was also a 44% increase in water usage.

The variations in annual water usage have been substantial - (2008 - 2.2 million gallons, 2009 - 2.7 million, 2010 - 3.6 million, 2011 - 3.2 million). The Owner has indicated that leaks in the water system resulted in increased consumption in 2010. However, after the system was replaced, in 2011, water usage was 44% above the 2008 level and 17.5% above the 2009 level..

Electricity costs increased by $14,448.26 or $18.02 / unit / month from 2008 to 2010. In percentage terms the electricity costs increased 28.6%. About 10% of the increase can be attributed to a 19.3% increase over the electricity rates which were in effect during the first half of 2008..[21] The current rates commenced with the utility charges after June 11, 2008 .

On the other hand, natural gas and heating fuel expenses decreased by $34,241.92 ($42.59 / unit / month between 2008 and 2010. This drop in gas heating costs exceeded the combined total of the increase in water and sewer and electricity costs.

From 2008 to 2010, property taxes increased by $12,444.96, an increase of $15.32/ apartment unit / month.

The combined costs of the on-site manager and the professional management firm increased by 22.8% , $24.35/ apartment unit/month from $85,986.06 in 2008 to $105,562.42 to 2010.

Insurance expenses in 2010 were $20,078.80 compared to $4,477.80 in 2008, but were equal to the insurance cost in 2009. The difference between the 2008 and 2010 cost levels is attributable to the fact that insurance expenses in 2008 were exceptionally low.

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21 The electricity rates increased from $0.1147 / kwh to $0.13297 / kwh.

3. Modifications to Cost Calculations for the Purposes of a Fair Net Operating Income Analysis

In this analysis several significant modifications are made to the operating expenses reported by the owner.

a. Maintenance and Repair Costs

Amortization of Capital Improvements

The replacements of the underground water pipes and the major repairs to the boiler were exceptional expenditures which would substantially increase the life of these systems, rather than annually recurring types of expenses.

The regulations provide for the amortization of capital improvement expenditures.

> D. Determination of Operating Expenses
> i. Allowable operating and maintenance expenses include reasonable expenditures for the following categories of expenses and other reasonable operating costs:
> ...i. Amortized cost of capital improvements
> 1. Capital improvements are additions to or the partial replacement of property that add to the value of the rental facility, appreciably lengthen its life or adapt it to a different use, and are required to be depreciated by the Internal Revenue Code.
> 2. The total cost of all capital improvements, including the interest allowance permitted pursuant to Takoma Park Code Section 6.20.090.B.8(a)v., shall be amortized over the useful life of the improvement.
> 3. The length of the amortization period shall be determined at the discretion of the Commission. In determining the length of the amortization period, the Commission may consider generally accepted accounting practices, the Internal Revenue Code, and regulations, guidance, and opinions of the Internal Revenue Service. (Section

In regards to the allowable interest allowance for capital improvements, the ordinance provides that the interest rate allowance for amortized capital improvements is equal to the federal reserve prime loan rate plus 2%.

> Amortized cost of capital improvements;
> An interest allowance shall be allowed on the cost of amortized capital expenses; the allowance shall be equal to the interest the landlord would have incurred had the landlord financed the capital improvement with a loan for the amortization period of the improvement, making uniform monthly payments, at an interest rate

equal to the Federal Reserve Board bank prime loan rate as of the date of the initial submission of the petition plus 2% per annum. (Section 6.20.090.B.8.a.v)

Currently, the prime rate is 3.25%, which in turn justifies the use of 5.25% interest rate in amortizing capital improvements under the MNOI standard.

Water Pipe Replacements

The cost of the water pipe replacements, including the pipes serving the heating system was $44,470.12 (See Application, Nov. 14, 2011, p. 235 and supporting documentation on the following pages) The expected life of these replacements is 15 years.[22]

When a 15 year amortization period is used, the annual amortized cost is $4,289.82 and the cost per apartment per month is $5.34 ($4,289.82 / (67 apartments x 12 months).

In order to place the significance of the selection of a particular amortization period in perspective, it is noted that the impact of alternate amortization periods on the allowable rent increase per apartment unit/ month is small. If a 20 year amortization period was used the cost per apartment per month would be $4.47. If a 10 year amortization period was used, the cost per apartment per month would be $7.12.

Boiler

The cost of upgrading the boiler was $24,663.79. (See Application, Nov. 14, 2011, p. 278 and supporting documentation on the following pages)

The boiler part replacements have a life expectancy of ten years.[23]

The annual amortized cost is $3,175.46 and the cost per apartment per month is $3.95 / apartment / month ($3,175.46 / (67 apartments x 12 months).

If the amortization period was 5 years the allowable amount per apartment per month would be $6.99 and if a 15 year amortization period was used the amount would be $2.96.

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22 Source:.Code Enforcement Supervisor, City of Takoma Park.

23 Source: Facility Maintenance Supervisor, City of Takoma Park, February 2012.

Calculation of Maintenance and Repair Expenses in Fair Return Analysis

In order to calculate Repair and Maintenance Expenses the expenses for the replacement of water system and heating system pipes and the overhaul of the boiler system, the total expenditures for these items are replaced by an amortized cost allowance.

b. Adjustment of Exceptional Expense Levels

The ordinance provides for the adjustment of expense levels which are atypical and do not represent a reasonable projection of ongoing expense levels.

> **When an expense amount for a particular year is not a reasonable projection of ongoing or future expenditures for that item, said expense shall be averaged with other expense levels for other years or amortized or adjusted by the CPI or may otherwise be adjusted, in order to establish an expense amount for that item which most reasonably serves the objectives of obtaining a reasonable comparison of base year and current year expenses. (Section 6.20.090.B.8.c.)**

In 2010, water and sewer expenses were exceptionally high, due to abnormally high water consumption levels in several months, which apparently were connected with the leaks in the water system. (See the following tables.)

Annual Water Consumption Levels

Year	Annual Consumption-Gallons
2008	2,211,000
2009	2,708,000
2010	3,571,000
2011	3,181,000

Months with Exceptional Water Consumption in 2010

Time Period*	2010 Avg. Consumption / Apartment Unit / Day/ (Gallons)	2008, 2009, & 2011 Avg. Consumption / Apartment Unit / Day (Gallons)
May 10 - June 11	187	124, 114, 115
Sept. 10 - Oct. 13	184	95, 109, 154
Oct. 14 - Nov. 12	226	85, 111, 103

* Ranges of dates in 2010.. Ranges of dates for comparison years vary; the most comparable date ranges were used.

The resulting increase in costs was greater than the percentage increase in consumption because water and sewer rates which are applicable to all consumption levels are graduated based on overall water consumption. For example if average water usage was from 100 to 149 gallons per day per unit, the overall rate on all of the usage was $6.76 / 1,000 gallons in 2010; if the consumption level was between 150 and 199 gallons, the overall rate on all of the usage was $7.70).[24]

There is no single correct determination of what size adjustment should be made of the 2010 water and sewer expenses. In this analysis, the allowable water and sewer costs for 2010 are established by adjusting the 2009 costs by the 8.6% percentage increase in 2010 rates over 2009 rates.

Adjusting the 2009 costs by 8.6%, results in an imputed cost for 2010 of $19,435 (17,901.81 x (1 + .086)).

c. The Reasonability of Management Expenses

The ordinance provides that:

> **iii. Management fees, whether performed by the landlord or a property management firm;**

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24 If the average consumption was from 100-149 gallons / day / unit the rates were $2.71 / 1,000 gallons for water and $4.06 / 1,000 gallons for sewer. If the average consumption was from 150-199 gallons / day / unit the rates were $3.04 / 1,000 gallons for water and $4.66 / 1,000 gallons for sewer.

....shall not exceed 6% of gross income unless the landlord demonstrates by a preponderance of the evidence that a higher percentage is reasonable. (Sec. 6.20.090.B.8.a.iii)

The tenants association comments note that management fees paid to Craig Lenkin, the son of the owner, exceeded the 5% level authorized by the contract.

While the contractual agreement may be enforceable by the parties, the parties also may make other arrangements. The issue in a fair return hearing is whether the expense level is reasonable.

The Apartment Owner reports a salary of $61,461.92 for the on-site manager and $44,100 for off-site management fees. The total of $105,562.42 is equal to 16.2% of rental income and $1,575 / apartment / year. The off-site management fee is equal to 6.8% of rental income and $658.22 / apartment / year. The on-site management cost is equal to 9.5% of the rent or $917.34 / apartment / year.

The Institute of Real Estate Management (IREM) annual income/expense analysis for conventional apartments provides data based on a sample of 82 garden apartment complexes in the Washington D.C. area.[25] The applicant's overall management fees (on-site and off-site) are a higher percentage of the rent than the average for professionally managed large garden type complexes in the Washington D.C. area. However, in terms of dollars per apartment unit it is equal to the average. The lower management fee to rent ratio for the IREM sample is attributable to the fact the average rents are substantially higher in the IREM sample, rather than a difference between dollar amount of management costs reported by the owner and the dollar average in the IREM sample.

d. Calculation of Overall Operating Expenses and Net Operating Income

The following table contains the income and expense data provided by the applicant and the adjustments made to that data for the purposes of a fair return analysis. In this analysis, the projected operating expense total for 2010 is $425,426.71 compared to the $498,179.55 total reported by the applicant.

25 Institute of Real Estate Management, 2011 Income/Expense Analysis: Conventional Apartments (National Association of Realtors, Chicago), p. 116.

Income, Operating Expenses, and Net Operating Income

(adjustments of applicant's projections in cells with bold outline)

		1990	2008	2009	2010	2010 adjusted
						(adjusted amounts in cells with bold outline)
	INCOME					
	Rent Per Unit/Month	535.48			808.91	
	Annual Rent	430524.00			650365.00	663276
	Air Conditioning				13045.00	
	TOTAL INCOME				663410.00	
	OPERATING EXPENSES					
G2	On Site Manager	Imputed 60% of Rental Income	51245.06	58754.86	61461.92	61461.92
G3	Prof. Mgmt Firm		34741.00	38741.00	44100.50	44100.50
G4	Self-Labor					
G5	Natural Gas		93421.61	73851.70	64083.79	64083.79
G6	Heating Fuel					
G7	Electricity		50673.33	53942.06	65161.59	65161.59
G8	Water & Sewer		13128.56	17901.81	28765.77	**19435.00**
G9	Grounds Maintenance		0.00	6136.00	8130.13	8130.13
G10	Bldg Maint & Repairs		24413.11	48946.96	93630.93	**31385.64**
G11	Painting & Decorating		3104.72	2747.75	2206.72	2206.72
G12	Self-Labor		0.00	0.00	0.00	0
G13	Misc. Supplies		0.00	0.00	0.00	0
G14	Real Estate Taxes		44933.67	48107.38	57178.63	57178.63
G15	Insurance		4447.78	20369.96	20078.80	20078.80
G16	Misc. Taxes & Insurance		300.00	300.00	300.00	300.00
G17	Legal Services		5236.00	6462.00	7802.00	7802.00
G18	Accounting Services		2250.00	2200.00	1300.00	1300.00
G19	Misc. Admin. Services		4268.19	1665.95	2008.98	832.20
G20	Rental Hsg License Fees		5963.00	6298.00	6298.00	6298.00
G21	Stormwater Fees		0.00	1466.74	1466.74	1466.74
G22	Misc. Fees & Assessments		330.00	393.40	121.00	121.00
G23	Cleaning Services		0.00		10953.96	10953.96
G24	Extermination Services		reported in G-9	8923.00	4411.00	4411
G25	Trash Collection & Recycle		8683.00	8571.50	8595.00	8595
G26	Misc. Contract Services		19576.72	8739.00	10124.09	10124.09
G27	TOTAL OPERATING EXP.	253592.00	366715.75	414519.07	498179.55	**425426.71**
	-					
	NET OPERATING INCOME	176932.00			165230.45	237849.29

Per Unit Per Month

Rental Income	535.48				808.91
Operating Expenses	315.41				529.14
Net Operating Income	220.06				295.83

III. Calculation of Rent Adjustment Pursuant to Fair Return Standard

The allowed operating expenses for 2010 were 67.8% over the imputed level of operating expenses in 1990. This increase compares with the 68% increase in the CPI from 1990 to 2010.

In dollar terms, the operating expenses for 2010 were $171,834.71 over the level imputed for 1990, an increase of $213.72/ apartment unit / month compared with rent increases of $273.43 / apartment unit/month during this period.

While the rent increases were adequate to cover operating cost increases they did not permit the amount of growth in net operating income required to provide a fair return. From 1990 to 2010, net operating income increased by $60,917.29 - $75.77 / apartment unit / month (from $220.06 / apartment unit / month to $295.83 / apartment unit / month.) In percentage terms the increase was 34.4%

As indicated, the ordinance provides for indexing net operating income by 70% of the percentage increase in the CPI from 1990 to 2007 and 100% of the percentage increase in the CPI since 2007.

> **Sec. 6.20.090 Rent increases pursuant to a fair return petition.**
>
> **B. Standards for Rent Increases Pursuant to a Fair Return Petition.**
>
> **1. Fair Return. Fair return is defined as base year net operating income adjusted by 70% of the percentage increase in the Consumer Price Index (CPI) from the base year until 2007, and 100% of the percentage increase in the CPI since 2007.**

The increase in the CPI from 1990 to 2010 was 77%,[26] which provides the basis for a 57% adjustment in the base period NOI.[27] From 1990 to 2007, the CPI increased by 60%. The applicable NOI adjustment for that period is 70% of the 60% increase in the CPI or 42%.. From 2007 to 2010, the CPI increased by 10.6%, providing for a 10.6% adjustment in the fair NOI for 2007. The overall

---

26 Administrative Regulations Sec. 2.B. The annual CPI shall be the Consumer Price Index - All Urban Consumers all items, Washington-Baltimore (Series ID: CUURA311SAO) published as of March of each year, except that if the landlord's Current Year is a fiscal year, then the annual CPI for the Current Year shall be the CPI published in December of the Current Year. (Exhibit A).

27 The calculation of the indexing adjustment has some complexity because the CPI index for the area, which had been in effect since 1970, was replaced by a new index with a new base date in 1996. Furthermore, the indexing ratio under the ordinance changed from 70% of the percentage increase in the CPI through 2007 to 100% of the percentage increase since 2007.

NOI adjustment in order to provide a fair NOI is 57% above the 1990 NOI level (The 42% increase over the base level is compounded by the 10.6% increase [1.42 x 1.106].)

Calculation of Fair Return Rent Adjustment

Base Year NOI	
Rental Income	**430,524.00**
Operating Expenses	**253,592.00**
NOI	**176,932.00**
Fair NOI Adjustment	
Indexing Pct. Adjustment of Base Year NOI	**57.0%**
Fair NOI - (Base Year NOI Adjusted by Pct Indexing Adjustment) (176,932 x 1.57)	**277,783.24**
Current NOI	**237,155.68**
Rent Adjustment (Fair NOI - Current NOI)	**40,267.16**
Rent Adjustment / Unit / Month	**$50.5**

Appendix A

Consumer Price Index Tables

CPI-All Urban Consumers (Old Series)

Series Catalog:

Series ID : MUURA315SA0

Not Seasonally Adjusted
Area : Washington, DC-MD-VA
Item : All items
Base Period : 1982-84=100

Data:

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Ann
1970		39.1			39.7			40.1			40.4		39.8
1971		41			41.4			41.8			42.1		41.6
1972		42.2			42.5			43.3			43.9		43
1973		44.3			45.2			46.2			47.2		45.7
1974		48.8			50			51.7			52.9		50.8
1975		53.5			54.2			55.3			56		54.7
1976		56.6			57.6			58.6			59		58
1977		60.3			61.5			62.6			63.5		62
1978	64.3		64.7		65.8		67		68		69.1		66.7
1979	70.7		72		73.2		74.7		75.5		76.3		74
1980	78.5		80.9		81.7		83.7		84.4		85.9		82.9
1981	87.1		88.8		89.7		90.5		92.1		93.3		90.5
1982	94.2		94.4		94.3		95.3		97		97		95.5
1983	98		98		99.2		100.6		100.7		101.2		99.8
1984	102.9		103.3		103.5		104.4		106		106.7		104.6
1985	106.6		108.1		108.3		109.5		109.6		110.7		109
1986	112.2		111.5		111.6		111.5		112.6		113.1		112.2
1987	113.7		114.5		115.3		116.2		117.8		118.5		116.2
1988	118.3		119.2		120.1		120.7		122.8		123.2		121
1989	124.3		126.1		127.1		127.8		130.1		130.5		128
1990	132		133.8		134		135.7		138		138.4		135.6
1991	139.1		139.3		140.9		140.9		143.3		142.6		141.2
1992	142.9		143		143.2		144.8		146		146.9		144.7
1993	147.8		148.5		149.2		149.2		149.7		150.9		149.3
1994	150.9		151.5		151.4		151.8		153.7		153		152.2
1995	153.8		155.1		154.7		156.1		156.2		155.2		155.3
1996	156.8		158.4		159		160.1		160.8		161.2		159.6
1997	161.6		161.9		162.1		162.9		163.6		161.8		162.4

Consumer Price Index - All Urban Consumers
Original Data Value

Series Id: CUURA311SA0,CUUSA311SA0
Not Seasonally Adjusted
Area: Washington-Baltimore, DC-MD-VA-WV
Item: All items
Base Period: NOVEMBER 1996=100
Years: 1996 to 2012

Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Annual
1996											100.0		
1997	100.4		100.8		100.5		101.1		101.4		100.5		100.8
1998	101.0		101.6		101.5		102.8		102.9		102.4		102.1
1999	102.8		103.2		103.6		104.6		105.4		105.0		104.2
2000	105.4		107.1		106.7		108.4		108.7		108.5		107.6
2001	108.9		109.7		110.1		110.8		111.7		110.9		110.4
2002	110.9		111.9		112.8		113.4		114.0		114.0		113.0
2003	114.6		115.9		115.7		116.8		117.2		116.7		116.2
2004	117.1		118.1		118.9		120.2		120.8		120.9		119.5
2005	121.3		122.7		123.6		125.0		126.7		125.4		124.3
2006	126.3		126.8		128.8		130.7		130.2		129.3		128.8
2007	129.956		131.945		132.982		134.442		134.678		135.151		133.464
2008	136.293		138.090		139.649		142.065		142.036		138.547		139.499
2009	137.598		138.620		139.311		140.810		140.945		140.718		139.814
2010	141.124		141.741		142.025		141.966		142.738		142.915		142.218
2011	144.327		146.044		147.554		147.747		147.658		147.565		146.975
2012	148.163												

MODIFIED PRELIMINARY ADMINISTRATIVE DECISION

April 19, 2012

FAIR RETURN RENT INCRESASE PETITION

CARROLL CARGENS APARTMENT COMPLEX

(26, 28, 30, & 32 Lee Avenue and 7401, 7403, 7011 Hancock Avenue)

Case # 2011-11L

TIME PERIOD FOR FILING WRITTEN OBJECTIONS TO MODIFIED PRELIMINARY ADMINISTRATIVE DECISION

The landlord and tenants may challenge the modified Preliminary Administrative Decision by filing written objections with the Commission. The written objections must be filed within 30 days of the date the Department sends this Corrected Preliminary Administrative Decision to the tenants, which is noted on the attached Certificate of Mailing. If no objections are filed within this period, this Corrected Preliminary Administrative Decision shall become the final decision of the Commission.

Objections should be mailed or submitted in person to: Commission on Landlord-Tenant Affairs, c/o Jean Kerr, 7500 Maple Avenue, Takoma Park, MD 20912 or submitted by email to: JeanK@takomagov.org

Kenneth K. Baar, Ph.D.

Rent Analyst on behalf of the Commission

April 19, 2012

CORRECTED PRELIMINARY ADMINISTRATIVE DECISION

The City of Takoma Park Commission on Landlord-Tenant Affairs hereby corrects its Preliminary Administrative Decision in this proceeding dated March 28, 2012. The Preliminary Administrative Decision erroneously calculated the rent increase awarded to the Landlord as a flat dollar amount applicable to every unit in the Property. In accordance with section 2(E) of the City of Takoma Park Administrative Regulations governing Fair Return Rent Increases, fair return rent increases are to be calculated as a percentage of the Current Year rents for the Property, and the increase for each unit is to be calculated by applying the percentage increase to the Current Year rent for each unit.

In this proceeding, the Current Year is 2010, and the percentage increase necessary for the Landlord to earn a fair return is 6%. Rather than awarding an increase of $50.53 per month per unit, the Preliminary Administrative Decision should have multiplied the Current Year rent for each unit by 6% to calculate the increase applicable to each unit.

The Tenants should disregard any Notice of Rent Increase issued pursuant to the March 28, 2010, Preliminary Administrative Decision.

This Corrected Preliminary Administrative Decision incorporates by reference the Preliminary Administrative Decision dated March 28, 2012, in its entirety, subject to the following modifications:

1. The Tables located on pages iii and 15 of the Preliminary Administrative Decision shall be replaced by the following table:

Calculation of Fair Return Rent Adjustment

Base Year NOI	
Rental Income	*430,524.00*
Operating Expenses	*253,592.00*
NOI	*176,932.00*
Fair NOI Adjustment	
Indexing - Pct. Adjustment of Base Year NOI	*57.0%*
Fair NOI - *(Base Year NOI Adjusted by Pct Indexing Adjustment) (176,932 x 1.57)*	*277,783.24*
Current NOI	*237,155.68*
Rent Adjustment *Fair NOI - Current NOI)*	*40,267.16*
Current (2010) Rental Income	*663,276.00*
Percentage Rent Adjustment (40,267.16 / 663,276.00)	*6%*

Rent Adjustment (Percentage of 2010 Rents) **6%**

2. The attached "Appendix B," which sets forth the rent increase authorized for each unit, shall be appended to the Preliminary Administrative Decision. The rent increases authorized in Appendix B shall be applied to the actual rent for the unit at the time of the increase and shall not preclude the Landlord from imposing an annual increase.

CITY OF TAKOMA PARK
COMMISISON ON LANDLORD-TENANT AFFAIRS
By:____________________________
Kenneth K. Baar, Ph.D.
Rent Analyst on behalf of the Commission
April 19, 2012

Appendix B

Address		6% Allowable Increase
Street	Apt. #	
26 Lee	100	$ 53.64
26 Lee	101	$ 51.72
26 Lee	102	$ 47.40
26 Lee	103	$ 52.02
26 Lee	201	$ 50.10
26 Lee	202	$ 45.84
26 Lee	203	$ 55.14
26 Lee	301	$ 51.72
26 Lee	302	$ 46.62
26 Lee	303	$ 58.14
		$ -
28 Lee	100B	$ 42.36
28 Lee	100	$ 43.92
28 Lee	101	$ 57.12
28 Lee	102	$ 45.78
28 Lee	103	
28 Lee	201	$ 54.06
28 Lee	202	$ 44.28
28 Lee	203	$ 56.64
28 Lee	301	$ 52.08
28 Lee	302	$ 42.24
28 Lee	303	$ 44.28
		$ -
30 Lee	101	$ 56.34
30 Lee	102	$ 44.70
30 Lee	103	$ 44.34
30 Lee	201	$ 51.30
30 Lee	202	$ 44.70
30 Lee	203	$ 47.94
30 Lee	301	$ 52.08
30 Lee	302	$ 44.70
30 Lee	303	$ 56.40
		$ -
32 Lee	100	$ 43.38
32 Lee	101	$ 52.02
32 Lee	102	$ 45.60
32 Lee	103	$ 48.48
32 Lee	201	$ 55.92
32 Lee	202	$ 45.12
32 Lee	203	$ 51.18
32 Lee	301	$ 56.34
32 Lee	302	$ 41.70
32 Lee	303	$ 59.52

Address		6% Allowable Increase
Street	Apt. #	
7401 Hancock	101	$ 47.58
7401 Hancock	102	$ 57.18
7401 Hancock	201	$ 54.30
7401 Hancock	202	$ 44.70
7401 Hancock	301	$ 57.60
7401 Hancock	302	$ 44.88
		$ -
7403 Hancock	100	$ 52.02
7403 Hancock	101	$ 54.60
7403 Hancock	102	$ 43.92
7403 Hancock	103	$ 52.44
7403 Hancock	201	$ 56.22
7403 Hancock	202	$ 45.72
7403 Hancock	203	$ 60.48
7403 Hancock	301	$ 58.80
7403 Hancock	302	$ 44.88
7403 Hancock	303	$ 57.78
		$ -
7411 Hancock	100B	$ 37.98
7411 Hancock	100	$ 45.60
7411 Hancock	101	$ 56.10
7411 Hancock	102	$ 43.08
7411 Hancock	103	$ 55.68
7411 Hancock	201	$ 57.12
7411 Hancock	202	$ 44.04
7411 Hancock	203	$ 49.08
7411 Hancock	301	$ 51.78
7411 Hancock	302	$ 48.06
7411 Hancock	303	$ 56.16

Average Allowable Increase in Dollars	$ 50.53
Average Monthly Rent	$ 837.03
Percentage Allowable Increase	6.04%